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**SECURITY INTERESTS UNDER THE UNIDROIT  
CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE  
EQUIPMENT 2001**

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**Thesis submitted to the University of Nottingham  
for the Degree of Doctor of Philosophy**

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This work examines security interests under the Cape Town Convention on International Interests in Mobile Equipment. The main purpose of the Convention is to provide a uniform legal regime for the creation, registration and protection of a creditor's interests held in high value types of mobile equipment, such as aircraft, railway and space objects. The Convention provides for the creation of an autonomous international interest in these types of equipment and establishes an electronic International Registry for recordation of interests in aircraft objects. The international interests are supported by an elaborate system of remedies exercisable in the case of the debtor's default or insolvency. These features of the Convention are aimed at promoting predictability and transparency in the financing of mobile equipment which should reduce the risks and costs of borrowing to the benefit of all stake holders.

The work examines such issues as the problems of the definition and creation of security interests as well as the possibility of the creation of a floating security under the Convention. It also explores the aims and assesses the effectiveness of the registration system established under the Convention. Next, the thesis examines the rules of the Convention on setting priorities between competing creditors. Finally, the work explored the remedies (and their effectiveness) available to the creditor.

One of the aims of this work is to examine the provisions of the Convention and to test whether the legal regime created by it can operate successfully and help facilitate financing of high value equipment. In order to test the effectiveness of the Convention, its provisions will be evaluated in the context of various factual scenarios, which, considering the absence of cases under the Convention, were largely inspired by the experience of some major domestic jurisdictions, such as the UK and the US. This exercise may also shed some light on strengths and weaknesses of the Convention in comparison with these systems.

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## Introduction

### 1. General

The financing and leasing of aircraft, railway and space objects can be a risky and highly unstable investment. The nature of these types of equipment is such that they are likely to constantly cross national borders which may render a creditor's interest in them unprotected.<sup>1</sup> It may take less than an hour for an aircraft or a train to leave the jurisdiction where the interests of a secured creditor, conditional seller or lessor in relation to these objects were created. If the equipment is relocated, the creditor may not always be certain that a validly created and enforceable interest held by it in the object will be recognised and protected in the new jurisdiction.<sup>2</sup> High mobility of aircraft and railway objects, as well as the fact that satellites are often intended to be launched into space, may also mean that conflict of laws rules pointing to, for example, the law of the location of the object (*lex rei sitae*) to govern the interests of a secured creditor, conditional seller and lessor in these objects may not be well suited.<sup>3</sup> Reliance on conflict of laws rules would also mean dependence on different jurisdictions with varying attitudes to security and retention of title transactions: while some jurisdictions may be supportive of creditor's rights, others may be less favorable.<sup>4</sup> The lack of international uniform substantive rules governing the rights of creditors in these types of equipment has in the past generated uncertainty and affected the availability of financing, which is particularly significant if the cost of these objects is taken into account.<sup>5</sup>

The main purpose of the Convention on International Interests in Mobile Equipment and its Protocols is to provide a uniform legal regime for the creation, registration and protection of interests of a secured creditor, conditional seller and

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<sup>1</sup> R Goode, *Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment: Official Commentary* (UNIDROIT, Rome 2008) 1.

<sup>2</sup> R Goode, H Kronke, E McKendrick, *Transnational Commercial Law: Text, Cases and Materials* (Oxford, OUP 2007) 434.

<sup>3</sup> G Mauri and B Itterbeek, 'The Cape Town Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific To Aircraft Equipment: A Belgian Perspective' (2004) 9 *Unif L Rev* 547, 550.

<sup>4</sup> Goode (n 1) 13.

<sup>5</sup> R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) 15 *Bond L Rev* 9, 10.

lessor held in high value types of mobile equipment, such as aircraft, railway and space objects.<sup>6</sup> One of the unique features of the Convention is that it provides for the creation of an autonomous international interest in these types of equipment which derives solely from the Convention and does not depend on any domestic law.<sup>7</sup> Another important creation of the Convention is an electronic asset-based International Registry of aircraft objects where international interests and other registrable interests in such equipment can be registered.<sup>8</sup> This should enable the creditor to give notice and secure priority among other holders of international interests in the object held by the debtor.<sup>9</sup> The international registries for registration of international interests in railway and space objects are expected to follow in due course. The international interests of the creditor are further supported by an elaborate system of remedies which can be exercised in the case of the debtor's default or insolvency.<sup>10</sup> These features of the Convention and the Protocols are aimed at promoting predictability and transparency in the financing of mobile equipment which should reduce the risks and costs of borrowing to the benefit of all stake holders.<sup>11</sup>

The Convention and Aircraft Protocol were concluded at the Diplomatic Conference held at Cape Town in October-November 2001 under the auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO).<sup>12</sup> The Convention<sup>13</sup> and Aircraft Protocol came into force on 1 March 2006, when the number of ratifications reached eight as required by the Aircraft Protocol.<sup>14</sup> The Rail

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<sup>6</sup> Preamble of the Convention. See Goode (n 1) 148.

<sup>7</sup> Art 2, the Convention. See Goode (n 1) 35; See L Weber and S Espinola, 'The Development of a New Convention Relating to International Interests in Mobile Equipment, in Particular Aircraft Equipment: a Joint ICAO-UNIDROIT Project' (1999) 4 Unif L Rev 463, 463-465.

<sup>8</sup> Art 16, the Convention.

<sup>9</sup> R Cuming, 'Considerations in the Design of an International Registry for Interests in Mobile Equipment' (1999) 4 Unif L Rev 275, 276-279.

<sup>10</sup> Chapter III of the Convention.

<sup>11</sup> Goode (n 1) 12.

<sup>12</sup> Ibid 7.

<sup>13</sup> There are currently 49 Contracting State to the Convention. The full list of the Contracting States can be viewed at: < <http://unidroit.org/english/implement/i-2001-convention.pdf> >.

<sup>14</sup> Art XXVIII, the Aircraft Protocol. There are currently 42 Contracting States to the Aircraft Protocol. The list of Contracting States is available at: < <http://unidroit.org/english/implement/i-2001-aircraftprotocol.pdf> >.

Protocol was concluded in Luxembourg on 23 February 2007<sup>15</sup> and the Space Protocol is still in the process of development.<sup>16</sup>

The idea that a uniform legal regime for creation and protection of security interests in mobile equipment should be established was first advocated by Mr TB Smith QC, a Canadian member of the Governing Council of UNIDROIT presiding over the Diplomatic Conference in Ottawa in 1988.<sup>17</sup> The desirability and feasibility of the project was further confirmed by positive responses to the questionnaire prepared by Professor R Cuming.<sup>18</sup> Great care was taken not only in drafting of substantive provisions of the Convention and Protocols, but also in ensuring that all interest groups were involved in their preparation. The exploratory working groups, as well as several specialist groups which were set up for the purpose of examining specific issues, such as Aircraft Working Group, Registration Working Group, Insolvency Working Group and Public International Working Group, consisted of a mixture of academic and practicing lawyers from different legal systems, representatives of relevant business organizations and, in the case of the Aircraft Protocol, participants from such organizations as ICAO and International Air Transport Association (IATA).<sup>19</sup> The consistent and close cooperation of various interest groups in the process of preparation of the Convention and Protocols was vital in ensuring that resulting documents reflected the needs and gained support of the industries concerned.<sup>20</sup>

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<sup>15</sup> The Luxembourg Protocol is not yet in force since the International Registry in relation to railway objects is not yet in operation as required by Art XXIII of the Luxembourg Protocol. For more details, see: <<http://www.unidroit.org/english/implement/i-2007-railprotocol.pdf>>. Last viewed on 31 October, 2011.

<sup>16</sup> The Diplomatic Conference for the adoption of the Space Protocol is due to be held in Berlin, Germany from 27 February to 9 March, 2012. For more details, see: <<http://www.unidroit.org/english/workprogramme/study072/spaceprotocol/conference/main.htm>>. Last visited on 31 October, 2011.

<sup>17</sup> Goode, Kronke and McKendrick (n 2) 434.

<sup>18</sup> Ibid 434.

<sup>19</sup> Ibid 434.

<sup>20</sup> Ibid 434.



## 2. Main features of the Convention

### a) Applicability

The Convention will apply if the following requirements are met. First, the parties must conclude a security agreement, a title reservation or a leasing agreement.<sup>21</sup> The agreement should relate to uniquely identifiable mobile equipment and comply with the requirements prescribed by the relevant protocol.<sup>22</sup> At present, the Convention only covers three categories of equipment, namely a) an airframe, an aircraft engine or a helicopter; b) railway rolling stock; and c) space assets.<sup>23</sup> The agreement must be constituted in accordance with the formalities stipulated by the Convention.<sup>24</sup> This means that the agreement should be in writing, relate to an object of which the chargor, conditional seller or lessor has power to dispose, enable the object to be identified in conformity with the Protocol and, in the case of the security agreement, enable secured obligations to be determined, but without the need to indicate the sum secured. Of these four formalities, the requirement of power to dispose may give rise to some important questions, which will be considered later in the work. The Convention does not explain in what circumstances the power to dispose may arise. It seems clear that the power to dispose includes the right to dispose, i.e. where the chargor, conditional seller and lessor are owners of the object or have authority of the owner to deal with it. But the power to dispose is wider than the right to dispose and covers other situations whereby a non-owner chargor, conditional seller or lessor can deal with the object in a way that will bind the true owner even if the latter did not authorise the disposition.<sup>25</sup> In this regard, it is suggested that the Convention's rules on priority may help identify the circumstances in which the power to dispose may arise.<sup>26</sup> Finally, the Convention will only apply if its requirement relating to the connecting factor, namely the location of the debtor is met.<sup>27</sup> The debtor should be

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<sup>21</sup> Art 2(2).

<sup>22</sup> Goode (n 1) 21.

<sup>23</sup> Art 2(3). Art 51 indicates that the application of the Convention can be expended in future to cover other types of mobile equipment through new Protocols.

<sup>24</sup> Art 7.

<sup>25</sup> R Goode, 'The International Interest as an Autonomous Property Interest' (2004) 1 ERPL 18, 24.

<sup>26</sup> Goode (n 1) 176.

<sup>27</sup> Art 3(1), the Convention.

situated in a Contracting State at the time of the conclusion of the agreement creating or providing for the international interest.<sup>28</sup> This means that if the debtor moves to another state after the agreement is made, the Convention will still apply. There are six alternative ways to determine whether the debtor is located in a Contracting State.<sup>29</sup> For instance, if the debtor is incorporated or formed, or has a registered office, a centre of administration, a place of business or habitual residence in a Contracting State where it is located at the time of the conclusion of the agreement the requirement of the connecting factor will be satisfied.<sup>30</sup> In contrast, the location of the creditor is irrelevant for the purpose of the Convention.<sup>31</sup> Article IV(1) of the Aircraft Protocol provides an alternative connecting factor in relation to a helicopter or an airframe pertaining to an aircraft. In the case of these objects, the Convention will also apply if the helicopter or the airframe is registered in a national aircraft register of the State of Registry.<sup>32</sup> The State of Registry means the State of the national register in which the aircraft is registered and the State of location of the common mark registering authority maintaining the aircraft register in accordance with Article 77 of the Convention on International Civil Aviation 1944.<sup>33</sup> The alternative connecting factor cannot apply to aircraft engines because there are, generally, no national registries in relation to these objects.<sup>34</sup>

#### b) The two-instrument approach

In the early stages of the project, it was expected that the Convention would consist of a single document relating to all types of mobile equipment which it intended to cover.<sup>35</sup> However, it soon became clear that the traditional route of

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<sup>28</sup> Art 3(1), the Convention.

<sup>29</sup> Art 4, the Convention.

<sup>30</sup> The main purpose of providing various alternative ways of establishing the connecting factor is to widen the applicability of the Convention. See Goode (n 1) 170.

<sup>31</sup> Art 3(2), the Convention.

<sup>32</sup> Goode (n 1) 22.

<sup>33</sup> Art I(h), (p), the Aircraft Protocol. The Convention on International Civil Aviation (the Chicago Convention) is a public law treaty designed to promote safe and secure flights, whereas the Cape Town Convention is a private law treaty and its main objective is to facilitate financing and leasing of aircraft, railway and space objects. The Cape Town Convention should not be, generally, interpreted by reference to the Chicago Convention. See Goode (n 1) 300.

<sup>34</sup> Goode (n 1) 111.

<sup>35</sup> R Goode, 'The Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment' (1999) 4 Unif L Rev 265, 269-271.

international treaty making may not be the most constructive one for the purposes of the Convention. The aviation working group was well ahead of the rail and space groups. If the drafters of the Convention were required to wait until all equipment groups completed their work, the progress of the project would have been subjected to a considerable delay.<sup>36</sup> To resolve the matter, the Aviation Working Group and IATA proposed a novel solution under which the Convention would only govern the issues relating equally to all types of equipment.<sup>37</sup> The Convention would then be complemented by the Protocols which would deal with specific issues relating to a particular type of equipment. The novelty of this proposal consisted of the idea that the Protocol should prevail over the Convention in the case of any inconsistency between the two instruments.<sup>38</sup> There was much debate about whether the two-instrument approach should be followed and the matter was only settled at the beginning of the Diplomatic Conference.<sup>39</sup> Another alternative was to have a set of stand-alone Conventions relating to each type of equipment.<sup>40</sup> But it was soon realised that this would only multiply the work as each time the drafters would have to reconsider and evaluate the provisions of the Convention.<sup>41</sup> More importantly, this approach could undermine the integrity and uniform application of the Convention.<sup>42</sup> In contrast, the novel solution of the base Convention supplemented by equipment specific Protocols had several advantages and was ultimately adopted at the Diplomatic Conference. It allowed each working group dealing with a particular type of equipment to proceed at its own speed.<sup>43</sup> Leaving the issues relating to specific types of equipment to the Protocols also meant that the text of the Convention could be kept as simple and clear as possible.<sup>44</sup> At the same time, the Protocols could be drafted in a way which could better reflect the nature of the equipment and the needs of industry. For example, aircraft objects are defined in the Protocol by reference to jet propulsion and horse power which, if incorporated into the

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<sup>36</sup> Goode, Kronke and McKendrick (n 2) 443.

<sup>37</sup> Ibid 444.

<sup>38</sup> C Chinkin and C Kessedjian, 'The Legal Relationship between the Proposed UNIDROIT Convention and its Equipment Specific Protocols' (1999) 4 Unif L Rev 323, 323-325.

<sup>39</sup> Goode, Kronke and McKendrick (n 2) 445.

<sup>40</sup> Goode (n 35) 269-271.

<sup>41</sup> Ibid 271.

<sup>42</sup> Ibid 271.

<sup>43</sup> Goode (n 1) 17.

<sup>44</sup> Ibid 17.

Convention, could render its text too technical. Finally, the separation of the base Convention and Protocols allows Contracting States to choose which Protocol to ratify which may help secure greater number of ratifications.

c) The international interest

The Convention is mostly concerned with three types of financing of mobile equipment. The debtor may obtain a loan secured by the aircraft, railway or space object, the creditor may sell the object to the debtor in a conditional sale or the object may be leased to the debtor.<sup>45</sup> Some jurisdictions, namely the United States, Canada and New Zealand, characterise conditional sale and some leases as security interests.<sup>46</sup> Other jurisdictions distinguish between 'true' security interests and conditional sale and leases and subject them to different legal regimes.<sup>47</sup> Since the agreement on uniform approach to characterisation for the purposes of the Convention could not be reached, it was decided that this issue should be left to the applicable domestic law.<sup>48</sup> But a solution which would reflect the differences between a security interest, conditional sale and a lease and still treat these arrangements in a similar way was still needed under the Convention. This gave rise to the creation of a truly unique concept of the international interest.<sup>49</sup> The Convention treats security interests, conditional sale and leases as international interests and subjects them to the same rules of creation, registration and priority. The distinction between them only becomes relevant at the time when creditor needs to exercise remedies because this is the only moment when the nature of its title in the object becomes important.<sup>50</sup> This is why the Convention provides separate remedial rules for the secured creditor and the conditional seller and lessor.<sup>51</sup> Although the Convention delegates the issue of characterisation to the applicable law, it too provides definitions of security

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<sup>45</sup> The Aircraft Protocol makes an exception for outright sale and prospective sale (which do not constitute international interests) of aircraft objects which can be registered for the purposes of priority in the International Registry. Art III, V, the Aircraft Protocol. See also Goode (n 1) 27, 309-310.

<sup>46</sup> Goode, Kronke, McKendrick (n 2) 450.

<sup>47</sup> Ibid 450.

<sup>48</sup> Goode (n 1) 169.

<sup>49</sup> Art 2, the Convention

<sup>50</sup> Goode, Kronke, McKendrick (n 2) 450.

<sup>51</sup> Art 8, 9 and 10, the Convention.

interest and the interests of a conditional seller and lessor.<sup>52</sup> The definitions of these terms under the Convention and applicable law may not always coincide, which raises important questions of the relationship between the two routes of defining and of which transactions may be governed by the Convention.

#### d) The International Registry

Another unique feature of the Convention is that it provides for the creation of an electronic asset-based International Registry for registration of international and other registrable interests in mobile equipment.<sup>53</sup> At present, only the aircraft registry is in operation and it is expected that separate registries will be created for other types of equipment.<sup>54</sup> The aircraft registry is situated in Dublin and has been operational since 1<sup>st</sup> March 2006. Registration allows a registered party to give notice of the possible existence of an international interest and secure its priority and effectiveness in the case of the debtor's insolvency.<sup>55</sup> The registrations and searches should be made against the object and not the name of the debtor which means that the objects should be uniquely identifiable.<sup>56</sup> This also means that international interests in future or after acquired property cannot be registered under the Convention.<sup>57</sup> This raises an interesting question of whether it is possible to create and register a floating security interest in aircraft and other objects under the Convention, an issue which will be considered later in this work.

#### e) Remedies

A registered international interest which cannot be enforced will not be of great value to its holder. To ensure that the international interest can be protected, the Convention establishes the remedial rules, which can be exercised in the case of the debtor's default or insolvency.<sup>58</sup> Since the conditional seller and lessor are often considered as owners of the object, the Convention distinguishes between

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<sup>52</sup> Art 1(q), (ii), (II), the Convention.

<sup>53</sup> Art 16, the Convention.

<sup>54</sup> Goode (n 1) 194.

<sup>55</sup> Ibid 49.

<sup>56</sup> Ibid 194-195.

<sup>57</sup> Ibid 194-195.

<sup>58</sup> Chapter III, the Convention.

remedies available to them and those exercisable by the secured creditor.<sup>59</sup> The Aircraft Protocol provides additional remedies of de-registration and export and physical transfer of the object to another jurisdiction.<sup>60</sup> This should enable the creditor to re-register the aircraft in a different jurisdiction which may be more favorable to the protection of its interests.<sup>61</sup> The Luxembourg Protocol also provides that in the case of the debtor's default, the creditor may physically transfer the railway object from the territory in which it is situated to another country.<sup>62</sup> Since repossession of the railway rolling stock may cause disruption to the carriage of passengers and freight, this remedy may only be exercised subject to the public service exemption.<sup>63</sup> This means that if the railway object is habitually used for the purpose of providing a service of public importance it may not be repossessed by the creditor.<sup>64</sup> One issue which needs to be and will be considered here is whether the creditor's interest is adequately protected and whether it can still obtain repayment of the debt.<sup>65</sup>

#### f) System of declarations

The Convention and Protocols provide for an elaborate system of declarations.<sup>66</sup> There are opt-in declarations, which must be made if a particular provision is to have effect in a Contracting State. For example, the Convention does not normally apply to pre-existing rights or interests, which remain subject to priority rules under the applicable law. However, a Contracting State can make a declaration under Article 60 indicating that the priority rules of the Convention will apply to pre-existing rights and interests if certain conditions are met. If a Contracting State wishes to exclude the application of certain provisions of the Convention, it can make an opt-out declaration. For instance, some jurisdictions do not allow extra-

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<sup>59</sup> Art 8, 9 and 10, the Convention.

<sup>60</sup> Art IX, the Aircraft Protocol.

<sup>61</sup> Goode, Kronke, McKendrick (n 2) 453.

<sup>62</sup> Art VII(1), the Luxembourg Protocol.

<sup>63</sup> B Bodungen and K Schott, 'The Public Service Exemption under the Luxembourg Rail Protocol: a German Perspective' (2007) *Unif L Rev* 573, 577.

<sup>64</sup> Art XXV, the Luxembourg Protocol.

<sup>65</sup> Similar issues arose in the drafting of the Draft Space Protocol as space objects often play a central role in delivering services of public importance in many States. See J Atwood, 'A New International Regime for Railway Rolling Stock Asset-Based Financing' (2008) 40 *UCC L J* 3 Art 2.

<sup>66</sup> The list presented here is not exhaustive. Declarations can also be made under Articles 40, 50, 52, 53 of the Convention. Several declarations can also be made under the Protocols.

judicial exercise of remedies. An opt-out declaration under Article 54(2) could preclude the creditor from exercising remedies available under the Convention without resorting to court. One of the remedies exercisable by a chargee on the debtor's default is the right to grant a lease of the object. This remedy is available subject to a declaration of a Contracting State precluding the grant of a lease of the object while it is located on or controlled from its territory.<sup>67</sup> A Contracting State may also make a declaration excluding provisions of the Convention dealing with relief pending final determination and issues of jurisdiction.<sup>68</sup> Some declarations, namely those relating to Article 48(2), on matters within the exclusive competence of the Regional Economic Integration Organisation and 54(2), on whether the remedies which, under the Convention do not require application to court, may be exercised only with leave of court, are mandatory and must be made to enable the Contracting State to become a party to the Convention. There are also declarations which can be made by a Contracting State in relation to matters of its own law. A declaration relating to non-registrable non-consensual rights and interests under Article 39 falls into this category. A Contracting State depositing such a declaration may indicate that certain non-consensual rights or interests which, under that State's law, do not require registration and prevail over an interest which is equivalent to the international interest, should be treated in priority to registered international interests under the Convention. Finally, there are declarations which may be made under the Protocols. The Aircraft Protocol provides two alternative sets of rules (Alternative A and Alternative B) in relation to the creditor's right of repossession which may be exercised in the case of the debtor's insolvency.<sup>69</sup> The Luxembourg Protocol adds a third alternative, Alternative C, to these options.<sup>70</sup> The Contracting State can declare which of the alternatives it chooses to apply on occurrence of insolvency related event or in the case of the debtor's insolvency. If none of the options is chosen, then the domestic insolvency rules will continue to apply.<sup>71</sup> The complex system of declarations under the Convention and Protocols may be

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<sup>67</sup> Art 54(1).

<sup>68</sup> Art 13, 43 and 55.

<sup>69</sup> Art XI, the Aircraft Protocol.

<sup>70</sup> Art IX, the Luxembourg Protocol.

<sup>71</sup> Goode (n 5) 18.

criticised as undermining their uniform application.<sup>72</sup> At the same time it may be argued that allowing Contracting States to retain their positions on important issues of policy may help secure greater number of ratifications.<sup>73</sup>

#### g) Interpretation of the Convention

A common feature of many international private law conventions is the requirement of their uniform application and respect of their international character.<sup>74</sup> This means that, similar to other conventions, the Cape Town Convention should be interpreted autonomously, i.e. in accordance with its own concepts and definitions. In other words, the provisions of the Convention should not be interpreted by reference to any domestic law.<sup>75</sup> This is clear from Article 5(1) of the Convention which states that:

*'In the interpretation of this Convention, regard is to be had to its purposes as set forth in the preamble, to its international character and to the need to promote uniformity and predictability in its application.'*

Article 5(2) provides guidance on how to proceed if a particular matter is not expressly settled in the Convention:

Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the applicable law.

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<sup>72</sup> Goode, Kronke and McKendrick (n 2) 461.

<sup>73</sup> The complex system of declarations under the Convention and the Protocols allowing Contracting States to retain their positions on important issues of policy could also help to promote '*commercially beneficial unification of law*'. See J Wool, 'Rethinking the Notion of Uniformity in the Drafting of International Commercial Law: A Preliminary Proposal for the Development of Policy-Based Unification Model' (1997) 2 Unif L Rev 46, 46-53.

<sup>74</sup> See Art 31(1) of the Vienna Convention of the Law of Treaties 1969; Art 7(1) of the Vienna Convention on International Sale of Goods 1980; Art 6 of the Convention on International Financial Leasing 1988; Art 4 of the Convention on International Factoring 1988.

<sup>75</sup> M Gebauer, 'Uniform Law, General Principles and Autonomous Interpretation' (2000) 5 Unif L Rev 683, 686-7.



This means that if the Convention does not expressly deal with a particular matter, it must, firstly, be ascertained whether this issue is governed by the Convention at all. As stated above, the Convention applies to asset-based financing and leasing of uniquely identifiable mobile equipment, such as aircraft, railway and space objects and there is a plethora of issues which may arise in this regard. Several such issues will arise in the course of this work and will be addressed in its relevant parts. Once it is established that the matter is governed by the Convention, it should be resolved in accordance with the general principles underlying the Convention. These principles include party autonomy, reflecting the fact that the parties engaged in the kind of transactions covered by the Convention will be knowledgeable and experienced and, for this reason, their agreements should, generally, be enforced; predictability in the application of the Convention, which is reflected in clear rules on priority; transparency, which can be observed through the rules of registration, making the interests of senior and junior creditors visible to other parties; and protection and ready enforceability of remedies in the case of the debtor's default or insolvency.<sup>76</sup> If the matter is found not to be governed by the Convention, it should be settled in accordance with the applicable domestic law.<sup>77</sup>

### 3. Aims of the work

The area of cross border security interests is fraught with numerous complicated issues, which stem from the multiplicity of jurisdictions with varying attitudes to security interests. While some jurisdictions are very supportive of secured creditors' rights in that they recognise non-possessory security interests which can be created with little formality and protected with readily available and adequate remedies that, in many cases, can be exercised extra-judicially, other jurisdictions can be more restrictive.<sup>78</sup> Another reason why this area of law is thought to be a complicated one is probably because of the variety of legal issues which have to be considered before a comprehensive security agreement can be put together.<sup>79</sup>

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<sup>76</sup> Goode (n 1) 18.

<sup>77</sup> Art 5(2), the Convention.

<sup>78</sup> P Wood, *The Law and Practice of International Finance Series, Volume 2: Comparative Law of Security Interests and Title Finance*, 2<sup>nd</sup> edn (London, Sweet & Maxwell 2007) 18-19.

<sup>79</sup> Wood (n 78) 3-4.

For instance, even before any security agreement can be entered into, a prospective secured creditor will be well advised to search the International Registry in order to ascertain whether the aircraft object is already encumbered and evaluate its potential priority standing among other creditors of the debtor.<sup>80</sup> The issues which must be taken into account here include the following. While some interests, such as non registrable non-consensual rights and interests may be binding even though they may not appear on the register, other interests, such as prospective international interests, which do appear on the register, may no longer be in existence. The potential secured creditor will also need to conduct a search of any declarations made by the Contracting State, because such declarations may affect its rights.<sup>81</sup>

The Cape Town Convention aims to provide a uniform set of substantive rules for the creation, perfection, priority and enforcement of security interests and interests of conditional sellers and lessors in mobile equipment, which, taking into account the complexity of the area is an ambitious task. One of the aims of this work is to examine the provisions of the Convention and the Protocols and to test whether the legal regime created by it can operate successfully and help facilitate financing and leasing of aircraft, railway and space objects. In order to test the effectiveness of the Convention, its provisions will be evaluated in the context of various factual scenarios, which, considering the absence of cases under the Convention, were largely inspired by the experience of some major domestic jurisdictions, such as the UK and the US. This exercise may also shed some light on strengths and weaknesses of the Convention and the Protocols in comparison with these systems.

The evaluation of the Convention will also involve the identification of questions the answers to which are not entirely clear. For instance, the concept of deficiency is not expressly mentioned in the Convention, which gives rise to the question of whether the secured creditor may claim the remainder of the debt if sale of the repossessed object did not generate enough proceeds to extinguish it. Another example is the notion of default under the Convention. ‘Default’ is defined as such a default which substantially deprives the creditor of what it is

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<sup>80</sup> The Legal Advisory Panel of the Aviation Working Group, *‘Advanced Contract and Opinion Practices under the Cape Town Convention: Cape Town Paper Series’*, Vol 2 (Oxford and Portland, Oregon, Hart Publishing 2008) 8.

<sup>81</sup> For more details see Chapter III of this work.

entitled to expect under the agreement.<sup>82</sup> But it is not entirely clear what constitutes the creditor's expectation under the agreement. Furthermore, it may be difficult to ascertain the breach of which terms may lead to substantial deprivation of such contractual expectation. This work will attempt to identify such issues and offer solutions or possible interpretations of the relevant provisions of the Convention.

This work will primarily deal with the issues of the definition, creation, registration, priority and enforcement of security interests under the Convention. Security interests in aircraft, railway and space objects are one of the most frequently used mechanisms which are employed to ensure repayment of the debt and to support financing of these types of equipment. In other words, it is their significance, effectiveness and frequency of use that explains this work's focus and scope. But the category of the international interest under the Convention is not confined to security interests and includes the interests of conditional seller and lessor. For this reason, these international interests will be touched upon to the extent that they help illuminate the concept of security interests. The Convention also deals with effect, formal requirements and priority of assignment of associated rights and international interests.<sup>83</sup> Since the main focus of this work is on security interests, the issues relating to assignment of associated rights and international interests are only briefly touched upon in the part of the work dealing with registrable interests under the Convention.

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<sup>82</sup> Art 11(2), the Convention.

<sup>83</sup> Chapter IX, the Convention.

## Chapter I: Definition and Legal Nature of Security Interests under the Convention

### 1. General

Credit was once described as the oil of a market economy;<sup>1</sup> something on which an enterprise's whole lifecycle may depend.<sup>2</sup> Regardless of whether the enterprise in question is a small family-run bakery or a large aircraft manufacturer delivering more than 400 aircraft annually and having more than 100 offices worldwide, it will need to invest funds in hiring staff, renting the premises, acquiring equipment and other incidents of running the business before it can start receiving any benefits of the trade. To make ends meet between the outlay of funds and the receipt of profits for further investment, the enterprise will often need to rely on a lender to provide much required funding.<sup>3</sup>

But how is the lender to ensure that the loan and the interest will be repaid in time or at all?<sup>4</sup> The borrower's financial circumstances may change dramatically over duration of the loan and even highly reputed enterprises may be forced into insolvency. When the borrower is faced with financial difficulties the lender may learn that the assets of the troubled enterprise are not sufficient to satisfy the claims of its other creditors: the employees may demand their wages, the rentals for the premises and the equipment may need to be paid, the debtor's trade creditors may demand payment for materials supplied or the return of their goods due to missed instalment payments, some of the borrower's creditors may have even obtained a court order for the payment of certain debts. The prospects of repayment may seem even bleaker if some of the borrower's key assets have been moved to a different legal system.<sup>5</sup> A lender, who has provided a railway operator with a loan for the acquisition of trains intended to be run on a new track connecting several countries, may find that as the queue of the debtor's creditors increase at the start of insolvency proceedings, the valuable trains are held by its

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<sup>1</sup> U Drobnič, 'Secured Credit in International Insolvency Proceedings' (1998) 33 *Tex Int'l L J* 53, 54.

<sup>2</sup> E McKendrick (ed), *Goode on Commercial Law*, 4<sup>th</sup> edn (London, Penguin Books 2010) 619-620.

<sup>3</sup> *Ibid* 620.

<sup>4</sup> J Simpson and J Rover, 'General Principles of Modern Secured Transactions Law' (1997) *NAFTA: L Bus Rev Americas* 73.

<sup>5</sup> P Larsen and J Heilbock, 'UNIDROIT Project on Security Interests: How the Project Affects Space Objects' (1998-99) 64 *J Air L Com* 703.

foreign creditors as hostages for the repayment of debts owed to them. In some cases, the circumstances may have changed so much that the property is no longer located on Earth at all! A lender financing an ambitious project on construction of a satellite may learn that the property will be difficult if not impossible to seize on the borrower's default or insolvency as it has been successfully launched into outer space.<sup>6</sup>

How is the lender to ensure that as the queue of the debtor's creditors becomes longer, it can still obtain full repayment of borrowed funds together with agreed interest? According to a principle of insolvency law well-known to many legal systems, the assets of the debtor should be distributed between the creditors on an equal or a *pari passu* basis.<sup>7</sup> In effect, the creditors should share the assets of the insolvent debtor in proportion to their pre-insolvency entitlements.<sup>8</sup> If the value of the debtor's assets is less than that of its liabilities, some creditors may receive less than expected or nothing at all.<sup>9</sup> Security interests are taken by creditors precisely to avoid the consequences of the *pari passu* principle.<sup>10</sup> By taking a valid security in some or all of the debtor's property, a secured creditor may ensure that in the case of the debtor's default or insolvency, it can apply such designated property to the discharge of the debt prior to distribution of the debtor's assets between other creditors.<sup>11</sup> A valid security can afford the secured creditor privileged treatment among other creditors in that its claims will, in many cases, be satisfied before the claims of unsecured creditors.<sup>12</sup> Effectively, the

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<sup>6</sup> S Davis, 'Unifying the Final Frontier: Space Industry Financing Reform' (2001) 106 Com L J 455, 459.

<sup>7</sup> D Cunningham and T Werlen, 'Cross-Border Insolvencies in Search of a Global Remedy' (1996) 15 Int'l Fin L R 51, 52. When recounting features of the insolvency proceedings which are common to many countries, the authors emphasised that in most countries a fiduciary (or administrator or trustee in bankruptcy) is, among other functions, entrusted with the task of fair distribution of the debtor's assets among the creditors on an equal or *pari passu* footing. For the manifestation of the *pari passu* principle under English law see s. 107 Insolvency Act 1986, rule 4.218 Insolvency Rules 1986.

<sup>8</sup> G McCormack, *Secured Credit under English and American Law* (Cambridge, CUP 2004) 11.

<sup>9</sup> McKendrick (n 2) 619-620.

<sup>10</sup> Ibid 619; G McCormack, *Registration of Company Charges*, 2<sup>nd</sup> edn (London, Jordans 2005) paras 1.14-1.15.

<sup>11</sup> P Machoka, 'The Need for Efficient and Effective Secured Transactions Regimes in Sub-Saharan Africa: the Case for Kenya' (2005) J Int'l Bank L Regulation 395.

<sup>12</sup> This principle is not without exceptions. Although, generally, secured creditors enjoy priority over unsecured creditors at the debtor's insolvency, many legal systems allow certain groups of unsecured creditors, such as preferential creditors, to be granted priority over certain groups of secured creditors for policy reasons. For a brief overview of various legal systems allowing preferential creditors priority over secured creditors see P Wood, *The Law and Practice of*

insolvent debtor's estate available for equal distribution between its creditors is said to be comprised of whatever remains after secured creditors have enforced their claims.<sup>13</sup>

The watershed between secured and unsecured creditors on the debtor's insolvency and the priority enjoyed by a secured creditor is not the only reason for taking a security in an attempt to ensure timely repayment of the debt. In many cases, the value of the object used as a security<sup>14</sup> for the performance of an obligation may be significantly larger than the amount of the debt. A secured creditor may take an enterprise's whole undertaking as a security for the repayment of a loan which is only worth a fraction of such an undertaking.<sup>15</sup> Because a secured creditor may enforce its security on the debtor's default, which may occur outside insolvency, the debtor may prefer to repay the debt rather than lose the property.<sup>16</sup> The consequences of the enforcement of security outside insolvency may be devastating to the enterprise's business.<sup>17</sup> In contrast, when the secured creditor enforces its security against an insolvent debtor, the latter may have little to lose. For this reason, security is often taken to secure performance of the debtor's obligation, which frequently amounts to repayment of the debt.<sup>18</sup>

The advantages of a validly created and perfected security interest which was granted to the secured creditor in its own country may be subverted if it has to be enforced in a different country. Among the problems which the secured creditor may encounter are, for instance, varied attitudes towards security interests in different legal systems. While some jurisdictions are sympathetic to security interests and allow them to be created with as little formality as possible in order to secure the performance of both present and future obligations, others may be less favourable.<sup>19</sup> In addition, although some jurisdictions may allow recognition

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International Finance Series, Volume 2: Comparative Law of Security Interests and Title Finance, 2<sup>nd</sup> edn (London, Sweet & Maxwell 2007) 231-233.

<sup>13</sup> H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (Oxford, OUP 2007) 5.

<sup>14</sup> Such property is often referred to as collateral. See L Gullifer (ed), *Goode on Legal Problems of Credit and Security*, 4<sup>th</sup> edn (London, Sweet & Maxwell 2008) n1.

<sup>15</sup> As was the case in an English Court of Appeal decision *In re Panama, New Zealand and Australian Royal Mail Company*, (1869-70) L.R. 5 Ch. App. 318, 319. In this case, the company was able to grant its undertaking worth more than £600,000 as a security for two loans totalling in £150,000.

<sup>16</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 18.

<sup>17</sup> *Ibid* 18.

<sup>18</sup> *Ibid* 18.

<sup>19</sup> Wood (n 12) 18-24.

of the foreign security interest provided that it is similar to the ones existent in the country of enforcement and is in line with this country's formal requirements on the creation and perfection,<sup>20</sup> some jurisdictions may simply not recognise foreign non-possessory security interests.<sup>21</sup> Some forms of security interests may be unfamiliar to a jurisdiction where a secured creditor hopes to enforce it.<sup>22</sup> The concern of the secured creditor in this case may be that its security will not receive the same treatment as it would have received in the country of origin.<sup>23</sup>

In view of the growing importance of security interests both in national laws and cross-border transactions,<sup>24</sup> the need for a uniform effective and adequate legal framework for security interests in personal property becomes evident.<sup>25</sup> Arguably, the international harmonisation of the law on security interests in personal property would be the ideal solution.<sup>26</sup> Several international organisations have already produced model laws on security interests.<sup>27</sup> However, some legal scholars consider the idea of an international convention comprising all major issues on security interests in personal property as too complex and unrealistic.<sup>28</sup> In this respect, the UNIDROIT Convention on International Interests

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<sup>20</sup> G Ferrarini, 'Foreign Law Mortgages, Hypotheques and Charges in Italy' (1991) 6 JIBL 191, 192.

<sup>21</sup> Ferrarini (n 20) 192. The author states that under Italian law non-possessory security interest over movables cannot be created and, as a consequence, foreign security of such form will not be recognised. For a similar position under Finnish law see H Waasgren, 'Rights of Financiers in Aircraft: a Finnish Perspective on the 2001 Cape Town Instruments' (2004) 9 Unif L R 557, 562.

<sup>22</sup> A floating charge, which has its origins in English equity, may serve as an illustration of such a security. See Beale, Bridge, Gullifer, Lomnicka (n 13) 6, for the discussion of the contribution of equity to the development of security interests under English law. See also G Kajtar, 'Hungary – Foreign Investment: Security for the Interests of Foreign Lenders' (1993) 8 JIBL 162, 163. In this article the author states that the concept of the floating charge is unknown to the Hungarian law of secured transactions.

<sup>23</sup> R Goode, 'Security in Cross-Border Transactions' (1998) 33 Tex Int'l L J 47, 48.

<sup>24</sup> One of the factors of growing importance of security interests in cross-border transactions seems to be the recent trend among industries traditionally financed by governments and governmental organisations (such as railway and space industries) to seek finance from private sector. H Rosen, 'Creating an International Security Structure for Railway Rolling Stock' (1999-2) 4 Unif L R 313, 314.

<sup>25</sup> S Gopala, 'Transnational Commercial Law: The Way Forward' (2003) 18 Am U Int'l L Rev 803; S Gopala, 'Securing Mobile Assets: The Cape Town Convention and its Aircraft Protocol' (2003) North Carolina J Int'l L Comm Regulation 59; C Bourbon-Seclet, 'Cross-Border Security Interests in Movable Property: An Attempt at Rationalising the International Patchwork: Part 1' (2005) JIBLR 419.

<sup>26</sup> Goode (n 23) 49.

<sup>27</sup> For instance, see: <<http://www.ebrd.com/country/sector/law/st/core/model/index.htm>> for the official text of the EBRD Model Law on secured finance. For an overview of the OAS (Organisation of American States) Model Law on Security Interests see B Kozolchuk and D Furnish, 'The OAS Model Law on Secured Transactions: a Comparative Analysis' (2006) 12 Southwestern J L Trade in Americas 235.

<sup>28</sup> Goode (n 23) 49.

in Mobile Equipment<sup>29</sup> which provides a uniform legal regime for the creation, registration, priority and enforcement of security interests in specifically defined mobile equipment of high value may represent a more limited, but effective solution.<sup>30</sup>

The present Chapter seeks to address the following issues. First, the problems of definition of security interest and international interest under the Convention will be considered. The Convention provides a broad definition of security interests and other financial devices, such as retention of title agreements and lease, which may perform a similar function to security interests. At the same time, the question of characterisation of such transactions is left to the applicable domestic law. The definitions of security interests, retention of title agreements and leases under the Convention and the applicable domestic law may not always coincide. This Chapter seeks to ascertain the relationship between the two alternative routes of defining various types of international interests. The Chapter also seeks to ascertain the legal nature of security and other international interests. The Convention does not expressly state whether international interests are personal or proprietary in nature. It is suggested that certain features of international interests (such as priority over subsequently registered and unregistered interests, ability to be traced into proceeds and effectiveness in the debtor's insolvency) may help to ascertain their legal nature.

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<sup>29</sup> The Convention is frequently referred to as the Cape Town Convention. See R Goode, *Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment: Official Commentary* (UNIDROIT, Rome 2002) 1.

<sup>30</sup> Goode (n 23) 49.



## 2. Definition of security interests

### 2.1 What is a security interest?

The issue of the definition of security interests is approached differently by various legal systems.<sup>31</sup> Rather than starting with a definition of security, some legal systems tend to examine a transaction in question by looking at the balance of rights and obligations of the parties in order to decide whether it falls into one of the forms of the recognised security interests.<sup>32</sup> Other legal systems look at the function of the transaction in question: if it performs the function of security it may be recognised as such even if it is labelled differently by the contracting parties.<sup>33</sup> As a result, a similar business arrangement may be treated as a security interest by some legal systems and not considered as such by others.<sup>34</sup> In spite of these diverse approaches to the issue of what amounts to a security interest, it seems that the general understanding of the concept of security is shared by most legal systems. Generally speaking, a security interest can be said to involve a grant of a right in a property by an obligor to an obligee in order to secure or ensure that the obligor will perform its obligation.<sup>35</sup>

When an aircraft manufacturer needs to construct a new aircraft it will need finance to cover the expenses involved in its construction. A financier, who is willing to provide the loan, may realise that the aircraft manufacturer will only be able to repay borrowed sums and interest when it sells the aircraft and obtains the

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<sup>31</sup> D Allan, 'Security: Some Mysteries, Myths & Monstrosities' (1989) 15 Monash U L Rev 337, 339. The author suggests that while civil law jurisdictions start with defining concepts and then identifying its incidents, common law jurisdictions look at the incidents of a transaction in question and, by reference to these, assign it to a particular category if necessary. Consequently, definitions and characterisations traditionally played a less important role in common legal systems.

<sup>32</sup> Such jurisdictions as those of England and Wales, Australia, Hong Kong, Malaysia and Singapore follow this approach. See P Ali, *The Law of Secured Finance: An International Survey Of Security Interests Over Personal Property* (Oxford, OUP 2002) 15.

<sup>33</sup> For instance, S. 1-201(35) of the United States Uniform Commercial Code (UCC) defines security interest as 'an interest in personal property...which secures payment or performance of an obligation'. As long as a transaction in question performs this function, it should be treated as a security. For this reason, a financial lease may sometimes be treated as a security interest. Similarly, a retention or reservation of title by a seller of goods is limited to a reservation of a security interest. See J White and R Summers, *Uniform Commercial Code*, 5<sup>th</sup> end (St Paul, Minn., West Group 2000) 716.

<sup>34</sup> S Worthington, *Proprietary Interests in Commercial Transactions* (Oxford, Clarendon Press 1996) 11.

<sup>35</sup> Gullifer (n 14) para 1-04.

proceeds of sale. In order to ensure that, in case of financial difficulties or insolvency, the borrower will honour its obligations and will not favour its other creditors instead of paying to the financier, the latter may take a security interest in the aircraft which is being constructed. By granting a right in the property, the borrower recognises that, in the case of the default, the financier will be able to exercise available remedies, which may include taking possession and sale of the object in order to discharge the borrower's debt. The threat of the enforcement of security interest may provide an additional incentive for the borrower to repay the debt.<sup>36</sup> The grant of a right in the property by way of security may also mean that even in case of the borrower's insolvency, the financier may be able to obtain discharge of the debt before the borrower's other creditors. In effect, by taking a security, the obligee can ensure that come what may, its interest will be protected.

## 2.2 The definition of security agreement under the Convention

Article 1 provides a comprehensive list of defined terms and the Convention and its Protocols<sup>37</sup> should be read in accordance with these definitions.<sup>38</sup> Article 1(ii) defines a security agreement as "an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure the performance of any existing or future obligation of the chargor or a third person". Several points flow from this broad definition of a security agreement.

First, because Article 1(ii) refers to a security "agreement", only consensual forms of security interests arising out of an agreement between the parties to a secured transaction are covered by this definition.<sup>39</sup> Therefore, any forms of non-

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<sup>36</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 18.

<sup>37</sup> The Aircraft Protocol was adopted at the Diplomatic Conference held under the auspices of UNIDROIT and the International Civil Aviation Organisation (ICAO) at Cape Town from 29 October to 16 November 2001. It entered into force on 01.03.2006. There are 42 Contracting States to this Protocol. The Aircraft Protocol was signed, but not yet ratified by the UK. The Luxembourg (Rail) Protocol was adopted on 23.02.2007, but it is not yet in force. For further information on the status of the Aircraft Protocol, see: <<http://www.unidroit.org/english/implement/i-2001-aircraftprotocol.pdf>>.

<sup>38</sup> R Goode, *Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*: Official Commentary (UNIDROIT, Rome 2008) 154. (Hereafter referred to as Commentary).

<sup>39</sup> P Honnebier, 'The New International Regimen Proposed by UNIDROIT as a Means of Safeguarding Rights in Rem of the Holder of an Aircraft under Netherlands Law' (2001) 6 *Unif L Rev* 5.

consensual security interests arising out of domestic law will be excluded from this definition. This does not mean that such interests are excluded from the scope of the Convention as it would considerably reduce its scope.<sup>40</sup> These interests are treated by the Convention as non-consensual rights or interests arising out of national law.<sup>41</sup> For instance, Article 40 allows a Contracting State to make a declaration that non-consensual rights and interests may be registered in the International Registry and then be treated as registered international interests.<sup>42</sup> Provided that a Contracting State made the appropriate declaration, a right of a creditor arising out of a legal right of retention where an aircraft engine has been taken for repair and the work has not been paid for by the debtor, may be registered in the International Registry. A registered non-consensual right or interest will be considered as an international interest and the creditor can benefit from having a priority over a subsequently registered international interest or an unregistered interest.<sup>43</sup>

Secondly, a security interest can be used to secure performance of existing and future obligations of the chargor or a third person. This means that a security agreement that secures “all obligations owed by the debtor to the secured creditor now or in future” will be valid under the Convention.<sup>44</sup> This may allow for a security agreement to be used as a continuing facility,<sup>45</sup> which may be particularly convenient in long-term projects. When the value of the collateral is greater than the loan, the parties may agree to use the same collateral for further advances, should the need for such advances arise. Thus, an airline intending to renew its fleet over a period of three years may offer its used aircraft as a security for the first advance which it intends to invest into the acquisition of the first aircraft. The parties may agree to use the same object for each new advance provided by the lender in future without the need to enter into a new security agreement. This will allow the parties to cut unnecessary transaction costs associated with legal fees and negotiation of the terms of the agreement. The Convention distinguishes between security over a future obligation, which it allows, and security in future

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<sup>40</sup> Goode, Commentary (n 38) 260. The author indicates that the declaration under Art 40 allows Contracting States to extend the application of the Convention to designated categories of non-consensual rights and interests.

<sup>41</sup> Ibid 24-25.

<sup>42</sup> Ibid 260.

<sup>43</sup> Article 29(1), the Convention.

<sup>44</sup> Goode, Commentary (n 38) 178 (Illustration 3).

<sup>45</sup> Gullifer (n 14) 1-14.

property, which it does not recognise. Since registration under the Convention is affected against a specifically identified object, it is not possible to use as collateral a property which does not yet exist, such as an aircraft, which does not have the manufacturer's serial number because it has not yet been constructed.<sup>46</sup> At the same time, provided that the collateral is sufficiently identifiable it should still be possible to use it as a security for all obligations owed by the debtor to the secured creditor now or in future.

This part of the definition also indicates that a chargor can use the collateral to secure performance of an obligation owed to the chargee by a third person. This position of the Convention seems to reflect a common feature of modern financing when companies forming part of a corporate group provide the lender with cross-guarantees securing performance of obligations of its member-companies.<sup>47</sup>

Thirdly, security interest may arise by a grant of an interest (including an ownership interest) in or over an object. The following points seem to emerge from this part of the definition.

a) An interest in a uniquely identifiable object

An interest under the Convention may only be granted in a uniquely identifiable object of a category of such objects which are listed in Article 2(3) and the relevant Protocols. These objects comprise such types of mobile equipment as aircraft, railway and space objects. Each Protocol provides further requirements for the identification of these objects. Article I of the Aircraft Protocol provides an exhaustive description of the types of aircraft, airframes, aircraft engines and helicopters by reference to their jet propulsion, shaft horsepower and other technical particulars.

b) Types of security interests

In principle, the Convention recognises a security by way of ownership transfer, or pledge, or charge, or any other form of consensual security in personal

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<sup>46</sup> Goode, Commentary (n 38) 50.

<sup>47</sup> Gullifer (n 14) 1-15.

property.<sup>48</sup> At the same time, the nature of the objects and business activity of the parties involved in secured transactions may serve as natural restrictions to the generous allowance of the Convention. For instance, a pledge which usually involves a delivery of actual or constructive possession of the object as a security of the performance of an obligation<sup>49</sup> is unlikely to be frequently used in cross-border transactions for obvious reasons. A debtor who is situated in jurisdiction A and intends to acquire a rolling stock in jurisdiction B in order to operate it in jurisdiction C may find it commercially impractical if in order to obtain finance for its acquisition, it needs to deliver constructive or actual possession of the rolling stock to the financier who is situated in jurisdiction D. Likewise, the financier, who may be a bank, may find it inconvenient if, in order to secure repayment of the debt, it has to take possession of the rolling stock, thereby not only depriving the debtor from the source of repayment of the debt, but also incurring expenses related to the maintenance of the object.

A transfer of ownership by way of security may represent a better working solution.<sup>50</sup> This way the debtor can transfer ownership of the object as a security for the performance of an obligation to the financier and retain its possession.<sup>51</sup> It will then be able to use the rolling stock and repay the debt out of proceeds received from its operation. Once the debt is repaid, the ownership will revert back to the debtor.<sup>52</sup> The problem which parties to a secured finance transaction may encounter with respect to this type of security is that not all jurisdictions recognise the transfer of ownership in a movable object as a valid security.<sup>53</sup> However, the broad definition prescribed by Article 1(ii) does not seem to exclude such a possibility. To the contrary, Article 1(ii) specifically provides that a chargor can grant to a chargee "...an interest (including an ownership

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<sup>48</sup> Goode, Commentary (n 38) 166.

<sup>49</sup> M Bridge and R Stevens (eds), *Cross-Border Security and Insolvency* (Oxford, OUP 2001) 18-19; D Arner, C Booth, P Lejot, B Hsu, 'Property Rights, Collateral, Creditor Rights and Insolvency in East Asia' (2007) *Tex Int'l L J* 515.

<sup>50</sup> Under English law, ownership may also be transferred by way of security by mortgagor to the mortgagee. Once the secured obligation is performed, the ownership should revert back to the mortgagor. See *Santley v Wilde* [1899] 2 Ch. 474; *Maugham v Sharpe* (1864) 17 CB NS 443; 141 ER 179. Transfer of ownership by way of security is used in some other countries too. See Drobnić (n 1) 58.

<sup>51</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 81.

<sup>52</sup> *Ibid* 82.

<sup>53</sup> G Mauri and B Itterbeek, 'The Cape Town Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific To Aircraft Equipment: A Belgian Perspective' (2004) 9 *Unif L Rev* 547, 549.

interest)...”. This may present a good opportunity for reform in those Contracting States which do not currently recognise this type of security in order to modernise national laws on security interests.<sup>54</sup> Furthermore, the Convention provides both necessary and sufficient requirements for creation of a security interest.<sup>55</sup> Provided that these requirements are met and a valid security interest is created, the absence of an equivalent interest in a national jurisdiction will be irrelevant.<sup>56</sup>

The use of such form of a non-possessory security interest as a charge, which is commonly understood to involve the appropriation of designated property to the discharge of a debt without transfer of ownership,<sup>57</sup> may prove controversial under the Convention. Security by way of charge may be potentially beneficial both to the debtor and the secured creditor in cross-border transactions because it allows the debtor to retain and use the object and at the same time keep it encumbered by the debt.<sup>58</sup> An English floating charge in its classical form is unlikely to arise under the Convention.<sup>59</sup> English law distinguishes between a fixed and a floating charge both of which may be taken against present and future property.<sup>60</sup> While the parties could in principle create a charge in respect of the present property, they could not do so in relation to future assets, since the Convention does not permit the use of a future property as collateral. The fixed charge allows a secured creditor to take a security in the debtor’s specific asset(s) and could, for this reason, be used under the Convention.<sup>61</sup> In contrast, the floating charge does not attach to a particular asset until some specified crystallising event occurs, e.g. the debtor’s default or insolvency.<sup>62</sup> Instead, the floating charge hovers over a specified fund of assets, comprising constantly changing objects, which allows the debtor to dispose of any of them without

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<sup>54</sup> Mauri and Itterbeek (n 53) 549.

<sup>55</sup> Art 7, the Convention.

<sup>56</sup> Goode, Commentary (n 38) 175.

<sup>57</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 102.

<sup>58</sup> Bridge and Stevens (n 49) 23.

<sup>59</sup> For a possibility of creation of a floating charge under the Convention and Protocols see Chapter II.

<sup>60</sup> *Holroyd v Marshall* (1862) 10 H. L. Cas. 191. For a general information on fixed and floating charges under English law and some legal problems in this area see S Atheton, ‘Charges over Chattels: Issues in the Fixed/Floating Jurisprudence’ (2005) *Comp Law* 10; R Good, ‘Charges Over Book Debts: A Missed Opportunity’ (1994) *LQR* 592; R Goode, ‘Charge-Backs and Legal Fictions’ (1998) 114 *LQR* 178; M Bridge, ‘Fixed Charges and Freedom of Contract’ (1994) *LQR* 340.

<sup>61</sup> *Agnew v Commissioner for the Inland Revenue* [2001] AC 710.

<sup>62</sup> *Re Florence Land and Public Works Company* (1871) 10 Ch D 530 CA; R Pennington, ‘The Genesis of the Floating Charge’ (1960) 23 *MLR* 630; R Gregory and P Walton, ‘Fixed and Floating Charges – a Revelation’ [2000] *LMCLQ* 123.

obtaining the creditor's consent.<sup>63</sup> Until crystallisation occurs, the secured creditor does not have an interest in any particular property of the debtor.<sup>64</sup> Because Article 2(2) prescribes that the interest of the creditor should relate to a particular object out of those listed in Article 2(3), it seems unlikely that the constitution of a floating charge (at least in its traditional form) would be possible under the Convention.

c) The debtor need not be the owner of the charged object

The wording of the definition that the chargor may grant "an interest (including an ownership interest)" seems to suggest that the debtor need not be the owner of the collateral and may transfer any interest it holds in collateral even if it is less than ownership.<sup>65</sup> An airline in need of a loan for the purchase of a new aircraft engine may offer one of its aircraft, which it uses as a lessee as collateral for the repayment of the debt. In this case, the debtor will not be able to transfer to the creditor an interest which is greater than its own. Should the secured creditor decide to enforce the security, its interest will be treated as that of the lessee and not the owner of the property.

d) The interest is granted for the purpose of securing the obligation

The definition stipulates that the security agreement is concluded only for the purpose of securing the performance of an obligation, such as repayment of the debt. Once the obligation is performed, the secured creditor's interest should cease to exist and the property should resume its unencumbered state.<sup>66</sup> The transfer of an interest to the secured creditor should not be absolute even if it is by way of transfer of ownership. In contrast, an agreement stating that the debtor agrees to transfer the property absolutely without the opportunity of redemption cannot amount to a security interest.<sup>67</sup>

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<sup>63</sup> *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; *Re Panama, New Zealand and Australian Royal Mail Company* (1870) 5 Ch App 318; *Hodson v Tea Company* (1880) 14 Ch D 459.

<sup>64</sup> *Re Cosslett (Contractors) Ltd* [1998] Ch 495.

<sup>65</sup> R Goode, H Kronke, E McKendrick, *Transnational Commercial Law: Text, Cases and Materials* (Oxford, OUP 2007) 450.

<sup>66</sup> *Gullifer* (n 14) 1-33.

<sup>67</sup> *Ibid* 1-33.

e) Security is by grant and not reservation of title

Finally, Article 1(ii) states that the security agreement must be by a grant of an interest. This part of the definition seems to imply that in order for a security agreement to arise the chargor must grant the interest which it has in the designated property by way of security. Consequently, a security interest may not arise by reservation of title by the creditor. So, a conditional sale agreement under which the creditor reserves the ownership over the assets until the purchase price is received will not amount to a security interest. It seems that this provision of the Convention strives to preserve the major distinction between traditional forms of security interests and other financial arrangements, such as conditional sale or lease, which perform a similar function to security interests, but are not treated as such by some legal systems. The distinction between true security interests and other devices which may perform a function of security lies at the heart of the so called formal v. functional divide. Since references to this divide will have to be made in the course of this Chapter, the section below will briefly consider its essence.

### 2.3 The essence of the formal v. functional divide

The seller, a French company with a place of business in France sold steel plate to the buyer, an Illinois company with places of business in the United States.<sup>68</sup> The sales contract provided that the seller “remains the owner of the goods up to the complete and total payment of all sums due”. The buyer took possession of the goods, but failed to pay the purchase price. The seller sought to recover possession of the steel only to learn that the buyer intended to pay for the purchased goods out of the credit extended to it by a Bank, which, in turn, took the steel as security for the repayment of the loan.<sup>69</sup> Had French law applied, the

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<sup>68</sup> *Usinor Industeel v. Leeco Steel Products*, United States, 28 March 2002, Federal District Court (Illinois), available at: <<http://cisgw3.law.pace.edu/cases/020328u1.html>>.

<sup>69</sup> Since the contract involved international sale of goods and France and the United States are both signatories of the UN Convention on International Sale of Goods (CISG), the rights and obligations of the parties to the sales contract were governed by this Convention. However, since Art 4(b) of the CISG states that it does not cover issues concerning “the effect which the contract may have on the property in the goods sold”, the court had to decide what national law to apply in order to ascertain the effect of the reservation of title clause contained in the sales contract. As the goods were located in Illinois, the court decided to apply the local law.



seller might have recovered possession of the steel, since it retained its ownership in the goods as the unpaid seller under the reservation of title clause contained in the contract.<sup>70</sup> However, on the facts of the case, the applicable law was that of the United States. Section 2-401(a) UCC provided that “Any retention or reservation by the seller of the title in the goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest”. Therefore, the seller, who thought that it had secured its position in case of the buyer’s default because it remained the owner of the goods, was reduced to the status of a secured creditor and title to the goods was transferred to the buyer. As a secured creditor, the seller should have perfected its interest by filing a financing statement, which it never did.<sup>71</sup> The Bank, on the other hand, perfected its interest in due course and took priority over the seller.

In effect, the question in the above situation turned on the issue of the definition of security interests. The retention of title clause was designed to secure the position of the seller, should the buyer default on the payment. But, was it a true security simply because it performed the function of one or was it a mere contractual provision reserving ownership until some condition necessary for its transfer to the buyer was met? In other words, should a transaction, the purpose of which is to secure the performance of an obligation be automatically defined as a true security or not? This question, which depends on notions of possession and ownership, lies at the heart of the formal v. functional divide.<sup>72</sup> While the formal approach distinguishes between true security interests and quasi security interests, which may perform the function of security, but are not treated as such by law, the functional approach does not recognise this distinction and treats transactions aimed at securing performance of obligations as security interests.<sup>73</sup> Each of these approaches will now be examined in turn.

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<sup>70</sup> See the Analysis of the judgment on the Domestic Law.

<sup>71</sup> S. 9-302(1). See also Official Comment to s.9-302(1) explaining that this provision states the general rule that filing of a financing statement is necessary in order to perfect a security interest under Art 9. See Uniform Commercial Code: Official Text and Comments, 2009-2010 edn, (West, Thomson Reuters 2009).

<sup>72</sup> Gullifer (n 14) 1-04.

<sup>73</sup> R Goode, *The Hamlyn Lectures: Commercial Law in the Next Millennium* (London, Sweet & Maxwell 1998) 63. (Hereafter referred to as *Hamlyn Lectures*).

i)The formal approach: true security interests and quasi security interests

Under the formal approach which is followed by most civil law jurisdictions, the United Kingdom and other legal systems belonging to the common law family outside North America and New Zealand,<sup>74</sup> the law broadly distinguishes between the grant by the debtor of an interest by way of security and the reservation of title by the creditor under reservation of title agreements such as conditional sale, hire-purchase and leasing.<sup>75</sup> According to this approach, true security interests generally arise when the debtor transfers or grants an interest in the collateral to the creditor as security for the performance of the obligation.<sup>76</sup> For instance, under German law, the debtor can transfer its title in the property to the secured creditor, or can deposit the goods with the creditor and confer on it a right of sale, or can unconditionally assign receivables due to it to the creditor for the purposes of security.<sup>77</sup> English law traditionally recognises only four forms of consensual security, namely the pledge, the contractual lien, the mortgage and the charge.<sup>78</sup> The debtor may grant by way of security its ownership (mortgage)<sup>79</sup> or deliver actual or constructive possession (pledge)<sup>80</sup> of the collateral, or simply encumber the property (charge)<sup>81</sup> as a security for the performance of the obligation. A contractual lien, which can arise out of the express terms of the contract or, if not explicitly provided for in the contract, by operation of law, may arise when the goods are initially delivered for the purpose other than security.<sup>82</sup> For instance, the goods delivered for the purpose of repair may be used as a security for the payments due to the creditor from the debtor.<sup>83</sup> Other financial and business arrangements which may perform security function will not be viewed as such in the eyes of English law.<sup>84</sup> Another example may be provided by the Polish Civil Code which states that for the creation of a valid mortgage over real property, the contract should, among other things, unequivocally declare that the owner of the

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<sup>74</sup> Ali (n 32) 15.

<sup>75</sup> Gullifer (n 14) 1-28.

<sup>76</sup> Ibid 1-28.

<sup>77</sup> See B Jakel in Bridge and Stevens (n 49) 99-101.

<sup>78</sup> Gullifer (n 14) 1-42.

<sup>79</sup> Bridge and Stevens (n 49) 20.

<sup>80</sup> Ibid 18.

<sup>81</sup> Ibid 23.

<sup>82</sup> Gullifer (n 14) 1-49.

<sup>83</sup> Ibid 1-49.

<sup>84</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 9.

property agrees to grant its interest by way of mortgage as security for the performance of the secured obligation.<sup>85</sup> Polish possessory pledge is only deemed to be effectively created when the debtor, who must be the owner of the pledged movable property, delivers it into the possession of the creditor or another agreed third party.<sup>86</sup> The Civil Code of the Russian Federation<sup>87</sup> and the Federal Law on the Hypothec (the Pledge of Immovable Property) of the Russian Federation<sup>88</sup> indicate that both possessory and non-possessory pledges of property presuppose that the pledgor grants to the pledgee its interest (which can be less than ownership) in the property as security for the performance of the obligation.<sup>89</sup> Finally, French law on security interests presupposes that, as a general rule, security over tangible movable property may only be created and perfected by physical delivery of the collateral to the pledgee or other agreed third party.<sup>90</sup> In each of the above examples, it is the debtor who may be clothed in such terms as the pledgor, the mortgagor or the chargor, who has to transfer or grant the interest which it holds to the secured creditor in order for a true security to arise.

Security interests recognised by national laws are not the only means which a financier may employ in order to provide its customer with the required finance while, at the same time, ensuring that it will be repaid.<sup>91</sup> Various business arrangements, which may be broadly defined as reservation of title transactions, may perform a function similar to that of security and at the same time possess other features which parties to a transaction may find more advantageous for their purposes.<sup>92</sup> Because of their chameleon nature, which allows them to serve as a security, reservation of title agreements are often described as quasi security

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<sup>85</sup> L Choroszuca, 'Secured Transactions in Poland: Practicable Rules, Unworkable Monstrosities and Pending Reforms' (1994) 17 Hastings Int'l Comp L Rev 389, 400.

<sup>86</sup> Polish law also recognises non-possessory pledges, but these are only available to banks. See Choroszuca (n 85) 404-406.

<sup>87</sup> *Гражданский Кодекс Российской Федерации, Части Первой*, The Civil Code of the Russian Federation, Part One, 30.11.1994, N 51- ФЗ. The Russian version of Civil Code is available at: < <http://www.9111.ru/materials/?dop=197> >.

<sup>88</sup> *Федеральный Закон об Ипотеке (Залоге Недвижимости)*, The Federal Law on the Hypothec (the Pledge of Immovable Property), 16.07.98, N 102-ФЗ, approved by the Council of the Federation on the 09.07.1998, adopted by the Parliament ('Gosudarstvennaya Duma') on the 10.07.1998. This federal law was first officially published in "*Финансовая Россия*" (Financial Russia), 1998, N 27 and "*Российская Газета*" (Russian Gazette), 1998, N137. The Russian version of the law is available at: < <http://www.akdi.ru/gd/proekt/069877GD.SHTM> >.

<sup>89</sup> B Bennett, 'Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns' (1999) 77 Tex L Rev 1443, 1447.

<sup>90</sup> M Gdanski in Bridge and Stevens (n 49) 59.

<sup>91</sup> For an overview of alternative financial solutions see McKendrick (n 2) 621.

<sup>92</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 177.

interests.<sup>93</sup> The financial arrangements which are usually discussed under the umbrella of reservation of title agreements include reservation of title clauses in conditional sale agreements, sales and lease-backs, hire purchase and leasing agreements. In addition, trusts which are aimed at achievement of a specific purpose may also sometimes be considered as quasi security interests. Each of these arrangements will now be subjected to a brief consideration.

#### a) Retention of title

The term '*retention of title*' may be confusing as it is sometimes used to describe at least two different phenomena.<sup>94</sup> It can be used to describe various financial devices which, broadly speaking, involve separation of ownership and possession between parties to a transaction.<sup>95</sup> This may occur when the debtor wishes to obtain goods, but would like to pay for them later.<sup>96</sup> The parties may agree to transfer possession of the object to the debtor to enable its use in the business. The ownership to the object may remain with the creditor as a security for the repayment of the sums due from the debtor.<sup>97</sup> Such financial devices may be described as retention of title agreements and hire purchase and leasing may serve as their examples.<sup>98</sup>

The term retention of title may also be used to refer to retention or reservation of title clauses which are frequently found in conditional sales agreements.<sup>99</sup> While there exist many varieties of retention to title clauses,<sup>100</sup> their general purpose seems to be universal.<sup>101</sup> By means of such a clause, the seller intends to reserve the ownership of the goods which are delivered to the buyer until the latter performs certain conditions, which frequently amount to payment

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<sup>93</sup> McCormack, Secured Credit (n 8) 51.

<sup>94</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 177.

<sup>95</sup> Ibid 177.

<sup>96</sup> McKendrick (n 2) 621.

<sup>97</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 178.

<sup>98</sup> Ibid 178.

<sup>99</sup> The legal basis of retention of title clauses under English law is to be found in Sale of Goods Act 1979, s 19(1).

<sup>100</sup> McCormack (n 8) 68.

<sup>101</sup> For a general overview of financial devices involving the transfer or retention of title see Beale, Bridge, Gullifer, Lomnicka (n 13) Chapter 5.

of the purchase price.<sup>102</sup> In effect, a valid retention of title clause may be used by the conditional seller as a security designed to ensure that the buyer will pay the purchase price.<sup>103</sup> Similar to security interests, a valid retention of title clause may also protect the conditional seller in the case of the buyer's insolvency.<sup>104</sup> Since the conditional seller retains ownership of the goods, they will not become part of the buyer's estate on insolvency and the unpaid seller will generally be entitled to repossess the goods.<sup>105</sup> In contrast to traditional security interests, retention of title clauses do not have to be registered.<sup>106</sup> This circumstance may be particularly advantageous to the parties intending to enter into several sales agreements as registering each clause every time a new agreement is concluded may be too burdensome.<sup>107</sup> In spite of the fact that retention of title clauses perform the function of security, English law, in line with strict application of the formal approach, does not consider them as true security interests. The main reason for this is that, in contrast to true security interests, the conditional seller (the creditor) does not rely on the debtor's grant of an interest, but rather retains its ownership until the obligation is performed.<sup>108</sup> Curiously, while English courts have accepted the validity of "simple" clauses, under which ownership to the goods is not to pass to the buyer until the purchase price is paid as well as "current account" or "all – money" clauses, which allow the seller to retain ownership until all debts and not just the purchase price due from the buyer are paid, they refused to treat more

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<sup>102</sup> G McCormack, 'Personal Property Security Law Reform in England and Canada' (2002) JBL 113, 133.

<sup>103</sup> Worthington (n 34) 41.

<sup>104</sup> *Clough Mill Ltd. v Martin* [1985] 1 W.L.R. 111, 122.

<sup>105</sup> Although the resulting effect of protection in case of the debtor's insolvency which can be achieved by a valid retention of title clause is similar to that of a true security, the nature of interests of the conditional seller and the secured creditor is different: while the secured creditor obtains discharge of the debt prior to other creditors of the insolvent debtor because of proprietary nature of interest which it has in the property of the latter, the conditional seller simply withdraws its own property from the insolvent debtor's possession. It seems that for this reason, a valid retention of title clause can afford a conditional seller super-priority even over a secured creditor. See Beale, Bridge, Gullifer, Lomnicka (n 13) 432.

<sup>106</sup> The position is different under the UCC, which states that the interest of unpaid seller under the retention of title clause amounts to a registrable security interest. S. 1-201(35) UCC. See Worthington (n 34) 11.

<sup>107</sup> McCormack (n 102) 124.

<sup>108</sup> The position is different in the jurisdictions adhering to the functional approach. In these legal systems, the conditional seller is considered as a secured creditor and both ownership and possession are transferred to the conditional buyer. See J Sampson and B Brown, 'Retention of Title under New Zealand's Personal Property Securities Act 1999' (2002) 17 JIBL, 102; M Bridge, R Macdonald, R Simmonds, C Walsh, 'Formalism, Functionalism, and Understanding the Law of Secured Transactions' (1999) 44 McGill L J 567, 587-598.

extended forms of retention of title clauses as such.<sup>109</sup> When the conditional seller attempts to retain its ownership in original goods which may be used by the buyer in the process of mixture or manufacture of new products, or in the proceeds received by the buyer as a result of sale of original goods, English courts usually treat these clauses as charges and not retention of title clauses.<sup>110</sup> This generally seems to happen because title to the goods is deemed to have passed to the buyer at the moment of irreversible mixture of original goods with other goods of the buyer, or sale of original goods to a third party.<sup>111</sup> On this view, the interest held by the conditional seller is considered to have been obtained by the grant by the buyer and not retention of title by the seller.<sup>112</sup>

The difference between true security interests by grant and quasi security interests by reservation of title seems to be followed with varied rigidity by various jurisdictions. While English law maintains very strongly that true security may only arise by the grant of an interest by the debtor to the creditor and not reservation of title by the creditor, other legal systems have a slightly different approach to this issue. German law, similar to English law, does not consider such retention of title agreements as leasing as a true security interest: the lessor is deemed to retain the unconditional title to leased goods and is entitled to terminate the lease and repossess the goods in case of the lessee's default.<sup>113</sup> At the same time, retention of title clauses, allowing the unpaid seller to retain ownership until the buyer performs conditions precedent to the transfer of the title, are seen as true security interests.<sup>114</sup>

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<sup>109</sup> *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch 25; *Armour v Thyssen Edelstahlwerke AG* [1991] 2 AC 339.

<sup>110</sup> *Re Peachdart Ltd* [1984] Ch 131. See McCormack, Registration (n 10) 5.64.

<sup>111</sup> *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch 25. In this case The Court of Appeal held that supplier's title to the resin disappeared once it was used in the process of chipboard manufacture.

<sup>112</sup> McCormack (n 10) 5.64; *Ian Chisholm Textiles Ltd v Griffiths* [1994] BCC 96.

<sup>113</sup> *Jakel in Bridge and Stevens* (n 49) 104.

<sup>114</sup> I Fletcher and O Swarting, *Remedies Under Security Interests* (London, Kluwer Law International 2002) 135.

## b) Hire purchase agreements<sup>115</sup>

Hire purchase may be considered as another form of retention of title agreement aimed at providing the creditor with security against the debtor's default.<sup>116</sup> Hire purchase is essentially a contract whereby the owner (the creditor) is letting the goods on hire to the hirer (the debtor) in return for the payment of rentals.<sup>117</sup> It is similar to the conditional sale considered above in that, the hirer like the conditional buyer, obtains possession of the goods and can use them in its business in return for periodic payments which can be termed as rental payments in case of the hire purchase or instalment payments in case of the conditional sale.<sup>118</sup> The two arrangements are also similar in the way they perform a security function: in both cases the owner/conditional seller retains ownership to the goods with a view to ensure that the hirer/conditional buyer will make timely payments.<sup>119</sup> Some legal systems, however, distinguish hire purchase and conditional sale on the basis that unlike the conditional buyer who is obliged to purchase the goods, the hirer has merely an option to do so, but may choose not to exercise that option.<sup>120</sup> Another difference between the two is that because hire purchase is not considered to be a sale, the hirer cannot transfer good title to a bona fide third party, should it decide to sell the hired goods.<sup>121</sup> Since hire purchase does not involve a grant of an interest by the hirer and is accomplished by the retention of title by the owner, English law, for instance, does not consider it as true security.<sup>122</sup> As a consequence, hire purchase does not generally require registration as many security interests do.<sup>123</sup>

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<sup>115</sup> See, generally, R Goode, *Hire Purchase Law and Practice*, 2<sup>nd</sup> Ed (Butterworth & Co Publishers Ltd 1970); A G Guest, *The Law of Hire Purchase* (Sweet & Maxwell 1966).

<sup>116</sup> A Diamond, 'A Review of Security Interest in Personal Property', HMSO, DTI, 1989.

<sup>117</sup> Beale, Bridge, Gullifer, Lomnicka (n13) 198.

<sup>118</sup> Ibid 198.

<sup>119</sup> H Johnson, 'Problems with Hire Purchase' (1993) 12 IBFL 39.

<sup>120</sup> Jobson v Johnson [1989] 1 WLR 1026.

<sup>121</sup> M Bridge, 'Form, Substance and Innovation in Personal Property Security Law' (1992) JBL 1, 6. But see s. 27 of the Hire Purchase Act 1964 indicating that, under English law, a trade or finance purchaser of a motor vehicle from the hirer takes subject to the interest of the owner. At the same time, an innocent private purchaser takes free from such interest. For a detailed treatment of this issue see Beale, Bridge, Gullifer, Lomnicka (n 13) 463.

<sup>122</sup> *McEntire v Crossley Bros Ltd* [1895] AC 457.

<sup>123</sup> Johnson (n 119) 39.

### c) Leasing agreements

Leasing may be considered as another variant of retention of title agreements.<sup>124</sup> Leasing involves transfer of possession of the goods by the lessor to the lessee for a certain period of time in return for rental payments.<sup>125</sup> There are different ways of structuring the transaction, but in a very basic form it starts with a lessee, who, having found the equipment it needs, approaches the lessor so that the latter can buy this equipment and lease it to the lessee.<sup>126</sup> In some cases, when the lessor does not wish to purchase the equipment itself, the lessee, who may have better knowledge of the particulars of the equipment it needs, may buy such equipment, sell it to the lessor and lease it back.<sup>127</sup> This is often referred to as sale and lease-back whereby “the buyer” (lessor) agrees to allow “the seller”(lessee) to retain possession of the equipment in return for the payment of a rent.<sup>128</sup> Alternatively, instead of leasing the equipment back, the seller may agree to re-purchase it at a later stage.<sup>129</sup>

English law distinguishes between conditional sale, hire purchase and lease on the basis that unlike conditional sale or hire purchase, leasing does not impose on the lessee an obligation or option to purchase the goods.<sup>130</sup> In fact, the title is never intended to be transferred to the lessee and is retained as security for the rental payments by the lessor.<sup>131</sup> There are different forms of leases reflecting the needs of particular industries and lessees,<sup>132</sup> but the most commonly accepted classification is that between operational and finance leases.<sup>133</sup> Operational lease usually denotes a short-term hire contract whereby goods which have a reasonably

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<sup>124</sup> See, generally, *Tolley's Leasing in the UK*, 4<sup>th</sup> edn (Butterworths Tolley Ltd 2002).

<sup>125</sup> Bridge, Macdonald, Simmonds, Walsh (n 108) 599.

<sup>126</sup> For a sample aircraft lease agreement, see: <http://contracts.onecle.com/restaurant/gecc.lease.1999.11.09.shtml>.

<sup>127</sup> McKendrick (n 2) 776.

<sup>128</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 208.

<sup>129</sup> Ibid 208.

<sup>130</sup> Ibid 204. The distinction between these transactions may become less clear if, as is often the case, the lessee under a finance lease is given the right to receive the proceeds of sale of the equipment. See *On Demand Information plc v Michael Gerson (Finance) Ltd plc* [2004] 4 All ER 734.

<sup>131</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 204.

<sup>132</sup> These needs may vary from a one day lease of equipment to large scale leases of high value items. There are many specialist companies of different sizes which specialise on leases of particular equipment. See, for example, a website of a big international leasing company, which specialises in leasing aircrafts and has the biggest aircraft manufacturers among its clients: <http://www.ilfc.com/index.htm>.

<sup>133</sup> McKendrick (n 2) 768.



long economic life are let on hire for short periods of time to different lessees.<sup>134</sup> In contrast, a finance lease is a true financial tool and denotes such transactions under which a lessor hires the goods out for the duration of their useful economic life to a lessee in return for rental payments.<sup>135</sup> Such rental payments amount to the return of sums which the lessor spends on the acquisition of the goods and the profit on the acquisition.<sup>136</sup> Just as retention of title clauses under the conditional sale and hire purchase, finance lease operates “in the nature of security”: the lessee has the possession of the goods, while the lessor secures periodic payments through retention of title in them as the true owner.<sup>137</sup>

#### d) Specific purpose loan

Another transaction which can operate as a security is a specific purpose loan or a Quistclose trust.<sup>138</sup> When the lender/payer provides a loan to the borrower/payee for a specific purpose, such as for the sole purpose of buying new equipment,<sup>139</sup> or to pay the dividends to the shareholders,<sup>140</sup> or to pay to third parties with whom the payer’s advertisements have been placed<sup>141</sup> and the money is kept separately in order to be applied in accordance with these objectives,<sup>142</sup> the lender may want to receive the money back if the purpose of the loan has failed. It is generally accepted that when the purpose of the loan fails, the borrower holds the money on a resulting trust for the lender.<sup>143</sup> This circumstance may become of vital importance for the lender in case of the borrower’s insolvency.<sup>144</sup> Just as true security, the Quistclose trust allows the lender to get the advanced money back

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<sup>134</sup> The operational leases do not perform the function of security. See Law Commission Consultation Paper No 164, Registration of Security Interests: Company Charges and Property other than Land, para 7.30. (Hereafter referred to as Consultation Paper).

<sup>135</sup> Consultation Paper (n 134) 7.30-7.34.

<sup>136</sup> Ibid 7.30-7.34.

<sup>137</sup> *On Demand Information plc v Michael Gerson (Finance) Ltd plc* [2004] 4 All ER 734, 743.

<sup>138</sup> The name comes from the English case *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567 (HL).

<sup>139</sup> *Re EVTR* [1987] BCLC 646.

<sup>140</sup> *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567 (HL).

<sup>141</sup> *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207.

<sup>142</sup> Although when the money is kept separately it may be easier to establish that it was paid for the accomplishment of a specific purpose, this requirement does not seem to be too strict. For instance, in *Twinsectra Ltd v Yardley* [2002] 2 All ER 377, the money was held at a general bank account of the payee’s solicitor and not a specific account.

<sup>143</sup> *Twinsectra Ltd v Yardley* [2002] 2 All ER 377, 403, per Lord Millet.

<sup>144</sup> R Pearce and J Stevens, *The Law of Trusts and Equitable Obligations*, 3<sup>rd</sup> edn (UK, Lexis Nexis Butterworths 2002) 529.

prior to the insolvent borrower's other creditors.<sup>145</sup> This feature of the special purpose loans seems to be a reflection on the circumstances in which the money is advanced: in many Quistclose trust type of cases, the lender was providing finance to a borrower in financial difficulties as a last attempt rescue operation and, understandably, required some security to meet the risks of such shaky investments.<sup>146</sup> In spite of its security function, the Quistclose trust is not considered to be a true security under English law.<sup>147</sup> The borrower/payee is deemed to be simply a conduit between the lender/payer and the accomplishment of the purpose.<sup>148</sup> For this reason, the borrower/payee does not obtain any interest in the money and consequently cannot grant anything back by way of security to the lender/payer.<sup>149</sup> Examined through these formalistic glasses, Quistclose trusts were not accepted into the true security club, which was recently affirmed in the Law Commission consultation paper on Registration of Security Interests.<sup>150</sup> Unlike a true security whereby the collateral is used in order to support another obligation, the special purpose trust does not make this distinction.<sup>151</sup> The money which is being advanced for the performance of a particular purpose is the subject-matter of the security itself.<sup>152</sup> The security provided by a special purpose trust is not intended to support repayment of the debt, but rather to ensure that the purpose of the loan will be accomplished.<sup>153</sup> Once the purpose is achieved, the secured position of the lender turns into the one of an unsecured creditor and its privileged position is lost.<sup>154</sup>

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<sup>145</sup> M Bridge, 'The Quistclose Trust in a World of Secured Transactions' (1992) 12 Oxford J Legal Stud 333, 345.

<sup>146</sup> Pearce and Stevens (n 144) 529.

<sup>147</sup> Worthington (n 34) 48.

<sup>148</sup> McCormack (n 102) 126.

<sup>149</sup> Worthington (n 34) 48.

<sup>150</sup> Consultation Paper (n 134) 7.54 – suggesting that special purpose trusts should not be subjected to registration requirements either because no security interest arises or, alternatively, any security arises by operation of law.

<sup>151</sup> Bridge, Macdonald, Simmonds, Walsh (n 108) 567.

<sup>152</sup> McCormack (n 8) 58.

<sup>153</sup> Ibid 58.

<sup>154</sup> *Twinsectra Ltd v Yardley* [2002] 2 All ER 377, para 72, per Lord Millet: 'If the money is properly applied the debt is unsecured'.

ii) The choice between a true security and a quasi-security interest and some issues of characterisation

The transactions shown above illustrate that apart from the legally recognised security interests, there exist many other ways<sup>155</sup> of meeting the client's needs by providing it with finance or possession of required goods and at the same time securing the creditor's position.<sup>156</sup> The parties to a transaction may decide to opt for either a true security or a quasi-security because they are treated differently by law which, in turn, may have important practical implications.<sup>157</sup> While security often requires registration,<sup>158</sup> quasi security interests generally do not, which means that there will be no publicity of the transaction and it will be faster and cheaper for the parties concerned.<sup>159</sup> If, following the debtor's default, the creditor repossesses and sells the collateral at the price exceeding the amount of debt, it may be entitled to keep the surplus in the case of a quasi-security,<sup>160</sup> but will have to hand it over to the debtor in the case of a true security.<sup>161</sup> The retained ownership of the object as a quasi-security will also provide the creditor with a super-priority badge on the debtor's insolvency: since the object belongs to the creditor, it will not constitute part of the insolvent debtor's estate and will have to be handed back to the owner before distribution among other secured and unsecured creditors may begin.<sup>162</sup> The main reason why quasi security creditors enjoy super-priority seems to stem from the nature of their interest in the object: as true owners they are simply claiming something that belongs to them and not

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<sup>155</sup> Apart from the transactions mentioned above, there exist many others, such as receivables financing, factoring, discounting of receivables, securitisation and 'repos'. For detailed examination of these financial devices see Beale, Bridge, Gullifer, Lomnicka (n 13) Chapter 5.

<sup>156</sup> McCormack (n 8) 51.

<sup>157</sup> Gullifer (n 14) 1-04.

<sup>158</sup> In English Law, Part 25 of the Companies Act 2006 states that particulars of charges, including mortgages, created by a company over many types of property and the charge document must be sent for registration within 21 days of the creation of the charge. Such chargers are deemed to be void against a liquidator or administrator and any creditor of the company unless registration requirements are complied with. See McCormack (n 10) 6.2. At the same time, not all security interests require registration. For instance, under French law, similar to many other legal systems, the pledge, which is dependent on delivery of possession of the collateral need not be registered, since the fact that the debtor no longer possesses the asset is considered to be a good notice to the world of the existence of a claim over such asset. See Gdanski in Bridge and Stevens (n 49) 65.

<sup>159</sup> Consultation Paper (n 134) 6.3.

<sup>160</sup> Ibid 6.4.

<sup>161</sup> *Re George Inglefield Ltd* [1933] Ch 1, 26-27, per Romer LJ.

<sup>162</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 180.

asserting their rights in the debtor's property as secured creditors do.<sup>163</sup> There may be other reasons for opting for either a true or a quasi- security. The financier may be precluded from lending a loan to the borrower, but allowed to provide the same finance by other means, such as buy and re-sell of the equipment to the borrower; the taxation expenditures may differ depending on the choice of the parties and the accounting considerations may also play a role when the choice is made by the parties.<sup>164</sup>

In some cases quasi security interests can mimic the functions of true security interests to such extent that it may become difficult to distinguish one from another.<sup>165</sup> For instance, a railway operator wishing to raise finance for the acquisition of a new rolling stock may sell some of its existing equipment to a finance house and agree to buy it back later. Such an arrangement may be seen as a true sale and buy-back transaction, whereby ownership passes to the creditor and the debtor agrees to retain possession and buy the property back by making instalment payments. In this way, the debtor may receive the required funds and continue to use the property. The creditor, on the other hand, may be seen as providing the loan to the debtor on security of equipment, which is being repaid by periodic payments with interest. In this case, the court will have to decide whether the transaction in question amounts to a security or a genuine sale and buy-back agreement. If it is found to be a genuine sale/buy-back – all is well. If, as the case may be, the court decides that the transaction is in fact a disguised loan on security, it may be found void for lack of registration or some other formality with which true security should comply. The problems of characterisation and the necessity to subject true and quasi security interests to different legal regimes raises questions as to whether quasi security interests should be treated as what they appear to be or as true security interests.<sup>166</sup> Some commentators in common law jurisdictions consider the formal approach which divides economically similar devices into different categories as artificial and unnecessarily complicating the law.<sup>167</sup> This issue was considered by many legal commentators

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<sup>163</sup> Gullifer (n 14) 1-28.

<sup>164</sup> McKendrick (n 2) 742-746.

<sup>165</sup> Ibid 645.

<sup>166</sup> Goode, Hamlyn Lectures (n 73) 62.

<sup>167</sup> Ibid 63.

and was most clearly emphasised in the Diamond report on security interests.<sup>168</sup> Professor Diamond suggested, amongst other things, that security interests and functionally equivalent quasi securities, such as retention of title agreements, should be equated and subjected to the same requirements of notice-filing or registration.<sup>169</sup> His proposals were drawn on the United States Article 9 of the Uniform Commercial Code, which essentially treats all devices intended to provide a security as true security interests.<sup>170</sup> The proposals contained in the Diamond report have not been adopted so far in England.<sup>171</sup> At the same time, some legal scholars suggest that it is merely a question of time and eventually the courts will accept quasi security interests into the category of true security interests.<sup>172</sup> Other jurisdictions, notably, Canada and New Zealand have shown more flexibility and, following legal reforms, welcomed the functional approach into their jurisdictions.<sup>173</sup>

iii) The functional approach: the unitary concept of security interest

The formal approach taken to the definition of the security interests is based on the distinction between true security, whereby the debtor grants an interest in the collateral to the creditor by way of security and reservation of title, whereby the creditor reserves its interest in the property to secure its position. This distinction has been widely criticised because both true and quasi security interests are designed to perform the same function, namely protection of the creditor against the debtor's default or insolvency by allowing it to have a privileged recourse to the property serving as security. Many legal systems have seen special reports on this matter questioning the existence of the distinction and inquiring whether the better approach would be to subject all such devices to the same legal regime.<sup>174</sup> It has even been argued that any device performing the function of security should

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<sup>168</sup> For the discussion of the Diamond Report and other reports on the subject see Consultation Paper (n 134) paras 1.27-1.31.

<sup>169</sup> Ibid 1.31.

<sup>170</sup> Ibid 1.31

<sup>171</sup> McCormack (n 10) 2.11-2.23.

<sup>172</sup> Bridge (n 121) 1.

<sup>173</sup> See, generally, I Davies, 'Floating Charges and Reform of Personal Property Legislation' (1988) Comp Law 47; N Howcroft, 'Canada: Security for Lending – Personal Property Security Act' (1988) JIBL 157.

<sup>174</sup> Ali (n 32) 19.

be treated as such by law.<sup>175</sup> This distinction is largely extinguished by the functional approach according to which many of security devices are considered as true security interests.<sup>176</sup> The functional approach was originated in Article 9 of the United States Uniform Commercial Code.<sup>177</sup> The drafting of the UCC was initiated by Mr William A. Schnader in 1940 and was first published as the “1952 Official Text” under the auspices of the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI).<sup>178</sup> The UCC is a comprehensive code dedicated to commercial issues and is comprised of 11 Articles, Article 9 being titled as Secured Transactions. The UCC has been revised on many occasions and the last revision was conducted in 2009-2010.<sup>179</sup>

The pre-Code US law on secured transactions, somewhat similar to the formal approach, recognised distinctions between various security devices and governed them by different laws.<sup>180</sup> This was changed by the 1962 version of Article 9, which introduced a new unitary concept of security interest, taking under its umbrella all old forms of security devices in personal property without regard to their form or location of title.<sup>181</sup> The key provisions of the Revised Article 9 for the purposes of understanding whether a transaction in question is governed by it are mainly s 1-201 (35) on “security interests”, s 9-109 on the “scope” and s 9-102 on the “definitions”.<sup>182</sup> Section 1-201 (35) defines a security interest as “an interest in personal property or fixtures which secures payment for performance of an obligation”. Accordingly, a transaction which confers only personal rights on the creditor will not be sufficient to create a valid security interest under Article 9.<sup>183</sup> In contrast, so long as the security device denotes some interest in the personal property it may amount to a security interest “regardless of

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<sup>175</sup> Allan (n 31) 345-346.

<sup>176</sup> Goode, Hamlyn Lectures (n 73) 63.

<sup>177</sup> G Warner, ‘The Anti-Bankruptcy Act: Revised Art 9 and Bankruptcy’ (2001) 9 Am Bankr Inst L Rev 3.

<sup>178</sup> W Schnader, ‘A Short History of the Preparation and Enactment of the Uniform Commercial Code’ (1967) 22 U Miami L Rev 1.

<sup>179</sup> For an overview of the previous edition of Art 9 UCC see D Garland, ‘Revised Art 9: Understanding the Changes to Secured Transactions’ (2001) 64 Tex Bar J 974.

<sup>180</sup> White and Summers (n 33) 709; See, generally, D Baird and T Jackson, *Security Interests in Personal Property: Cases, Problems, and Materials*, 2<sup>nd</sup> edn (New York, The Foundation Press, Inc. 1987); G Gilmore, *Security Interests in Personal Property* (Boston & Toronto, Little, Brown and Company 1965).

<sup>181</sup> Broude in Bridge and Stevens (n 49) 50.

<sup>182</sup> White and Summers (n 33) 713.

<sup>183</sup> Ali (n 32) 21.

its form”.<sup>184</sup> This means that in addition to traditional security interests, such as pledges, mortgages and charges, Article 9 will regard many others, such as some leases, consignments, retention of title clauses under conditional sales, account receivables financing, factoring, deposit accounts and other security devices as true security interests.<sup>185</sup> At the same time, however broad Article 9 appears to be, some devices will be out of its reach. For instance, subordination agreements, allowing one creditor of the debtor to agree to subordinate its claim to that of another creditor, and negative pledges, prohibiting the debtor to create a new security interest in its property until the debt to the present secured creditor is paid, are not considered to be security interests.<sup>186</sup>

Article 9 provides a comprehensive set of legal rules guiding a security interest through its major development stages: attachment, perfection, priority and enforcement.<sup>187</sup> Attachment refers to all necessary steps that should be taken by the parties in order to create a security interest which will be valid between the creditor and the debtor.<sup>188</sup> Perfection of the security generally denotes the steps which should be further taken by the parties in order to secure the position of the secured creditor as against third parties.<sup>189</sup> One usually “perfects” by filing the financing statement or taking control or possession of the collateral in order to publicise its position of a secured creditor to the world at large.<sup>190</sup> At the stages of priority and enforcement, the secured creditor’s position in the line of other secured creditors is determined and it is then able to exercise the remedies under Article 9.

Article 9 enjoyed a warm reception from around the globe and was called by some legal scholars as “fundamentally sound,”<sup>191</sup> “rational and modern”,<sup>192</sup> “awe

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<sup>184</sup> S 9-109(a)(1) UCC.

<sup>185</sup> Garland (n 179) 974.

<sup>186</sup> White and Summers (n 33) 715; For a view from a different jurisdiction see, for example, J Arkins, ‘OK-So You’ve Promised, Right? The Negative Pledge Clause and the Security it Provides’ (2000) JIBL 198.

<sup>187</sup> S Harris and C Mooney, ‘The Art 9 Study Committee Report: Strong Signals and Hard Choices’ (1993) 29 Idaho L Rev 651, 569.

<sup>188</sup> Davies (n 173) 48.

<sup>189</sup> White and Summers (n 33) 748.

<sup>190</sup> Ibid 757. Not all security interests in all types of objects should be perfected under Article 9 UCC: security interests in aircraft should be perfected according to a federal law in Oklahoma City. See White and Summers (n 33) 758.

<sup>191</sup> H Ruda, ‘Art 9 Works - How Come?’ (1994) 28 Loy L A L Rev 309, 309.

<sup>192</sup> J Ziegel, ‘The New Personal Property Security Regimes – Have We Gone too Far?’ (1989-90) 28 Alta L Rev 739, 741.

inspiring, scary and spectacular”<sup>193</sup> and simply “genius”.<sup>194</sup> Such countries as New Zealand,<sup>195</sup> Canada (with the exception of the civil law province of Quebec),<sup>196</sup> Gaza and the West Bank drafted their Personal Property Security Acts on the model of Article 9.<sup>197</sup> Article 9 also inspired several international initiatives in the field of security interests in personal property.<sup>198</sup> It is generally thought to eliminate such problems associated with the formal approach as compartmentalisation, complexity and difficulty in determining priorities.<sup>199</sup> Instead of grouping different security devices into various compartments and subjecting them to different laws, Article 9 provides a single uniform legal regime for all of them ridding the system of the unnecessary complexity.<sup>200</sup>

The much praised unitary concept of Article 9 and the functional approach in general is not, however, welcomed by all.<sup>201</sup> Australia and England and Wales, after several reports in favour of the functional approach, did not conduct legal reforms in order to bring their laws on security interests in line with Article 9.<sup>202</sup> Some legal scholars commented that the unitary concept of security interests brought more confusion than clarity into the question of the very essence of a

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<sup>193</sup> H Hughes, ‘Aesthetics of Commercial Law – Domestic and International Implications’ (2007) 67 *Louisiana L Rev* 689, 730-732.

<sup>194</sup> R Cuming, ‘Article 9 North of 49: The Canadian PPS Acts and the Quebec Civil Code’ (1996) 29 *Loy L A L Rev* 971, 989.

<sup>195</sup> On the discussion of the New Zealand Personal Property Security Act see, for example, H Gabriel, ‘The New Zealand Personal Property Securities Act: A Comparison on the North American Model for Personal Property Security’ (2000) 34 *Int’l L* 1123; R Carnachan and M King, ‘New Zealand: Personal Property Securities Act 1999’ (2001) 3 *J Int’l Fin Markets* 80; C Taylor and M King, ‘New Zealand: Personal Property Securities Act’ (1999) 1 *J Int’l Fin Markets* 75.

<sup>196</sup> For a general discussion of the Canadian Personal Property Security Acts see, for example, N Howcroft, ‘Canada: Security for Lending – Personal Property Security Act’ (1988) 3 *J Int’l Bank Law* 157; R Cuming and C Walsh, ‘Revised Art 9 of the Uniform Commercial Code: Implications for the Canadian Personal Property Security Acts’ (2000-2001) 16 *Bank Fin L Rev* 339; M Sheppard and L Champion, ‘The Personal Property Security Act of Alberta – Implications for Oil and Gas Lenders’ (1991) 29 *Alta L Rev* 33.

<sup>197</sup> Bridge, Macdonald, Simmonds, Walsh (n 108) 569.

<sup>198</sup> J Spanogle, ‘A Functional Analysis of the EBRD Model Law on Secured Transactions’ (1997) *NAFTA: L Bus Rev Americas* 82; F Dahan and G McCormack, ‘International Influences and the Polish Law on Secured Transactions: Harmonisation, Unification or What?’ (2002-3) 7 *Unif L Rev* 713; I Davies, ‘The New Lex Mercatoria: International Interests in Mobile Equipment’ (2003) 52 *ICLQ* 151, 154.

<sup>199</sup> McCormack (n 8) 64; A McKnight, ‘Professor Diamond’s Review of Security Interests in Property other than Land in Great Britain’ (1986) 1 *JIBL* 207. The issues of priorities will be examined in Chapter IV.

<sup>200</sup> McCormack (n 8) 64.

<sup>201</sup> For detailed analysis of the functional approach and Article 9 UCC see Bridge, Macdonald, Simmonds, Walsh (n 108) 567.

<sup>202</sup> *Ibid* 567.



security interest and that this concept should not be taken at face value.<sup>203</sup> For instance, retention of title clauses, which highlight that ownership of the property is reserved by the conditional seller, are treated as a security interest under Article 9.<sup>204</sup> The traditional English law distinction between “simple” and “all debts” retention of title clauses and more advanced “proceeds” and “products” retention of title clauses, which are construed as charges, is irrelevant under Article 9. Instead, the conditional seller is considered not as the owner reserving its title, but as a secured creditor.<sup>205</sup> Once the debtor (conditional buyer who becomes the owner of the goods) obtains possession of the goods, the creditor’s (conditional seller’s) claim is equated with that of the claim of a secured creditor.<sup>206</sup> It follows that to be able to compete with other secured creditors of the buyer, the conditional seller has to file the financing statement or, in other words, perfect its security to avoid being treated as an unsecured creditor.<sup>207</sup> The previously taken-for-granted ‘super-priority’ enjoyed by the conditional seller as a true owner is denied to it under the functional approach and must be clawed back by filing of the financing statement or complying with Article 9 requirements for the perfection of the purchase money security interest.<sup>208</sup> Another consequence of the functional approach applied to the retention of title is that on repossession, the conditional seller is no longer entitled to deal with the goods as the owner: it cannot simply put them back into its warehouse in pursuit of a better buyer, or sell them at a profit and invest the money as it thinks fit.<sup>209</sup> As a secured creditor it has to sell them and account for any surplus to the buyer.<sup>210</sup> Viewed from this perspective, the functional approach may seem to disrupt the general perception

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<sup>203</sup> Ibid 574.

<sup>204</sup> McCormack (n 8) 39-99.

<sup>205</sup> S. 9-110 UCC provides in part that a security interest arising under s. 2-401 (seller who retains title as security interest), s. 2-505 (seller who ships under reservation of title), s. 2-711(3) (buyer in possession of rejected goods) is subject to Article 9.

<sup>206</sup> White and Summers (n 33) 741.

<sup>207</sup> Ibid 714.

<sup>208</sup> Purchase money security interest are generally said to arise when the creditor provides the debtor with funds in order to enable the latter to purchase specific goods and are in fact used for that purpose. Such PMSI are granted super priority status which upsets the general rule of priorities of Article 9 according to which priority is granted on the basis of first-to-file criterion. See White and Summers (n 33) 760-763.

<sup>209</sup> Bridge, Macdonald, Simmonds, Walsh (n 108) 592-593.

<sup>210</sup> Ibid 592-593.

shared by business persons of what amounts to the conditional sale and reservation of title clauses.<sup>211</sup>

Furthermore, the functional approach does not completely eliminate the problem of characterisation of security devices into true and quasi security interests. While Article 9 applies to many true and quasi security interests at the level of perfection and priority, some of them still need to be distinguished at the stage of enforcement<sup>212</sup> or for purposes other than Article 9.<sup>213</sup> In one Canadian case<sup>214</sup> the Supreme Court had to decide whether an arrangement in question amounted to an absolute assignment of receivables or to the assignment of debts by way of security only. Typically, under such an arrangement the debtor/seller sells the debts which are owed to it by a third party (account debtor) to the creditor/buyer.<sup>215</sup> In return, the creditor/buyer provides the debtor/seller with the finance it needs. The arrangement may amount to an outright or absolute assignment or “sale” whereby the creditor/buyer receives the absolute title in the debts. As the true owner the creditor/buyer is entitled to any surplus which may result from collection of the debts (since the amount of collateral may exceed the amount of the secured obligation).<sup>216</sup> Alternatively, it may denote an assignment by way of security only, so that the debtor retains a residual interest in the collateral. In this case, the debtor may ‘redeem’ its interest in the debts once it repays the loan provided by the creditor. In spite of this distinction, both transactions provide the debtor/seller with the required finance and allow the creditor/buyer to enjoy security in the assigned debts. For this reason, under the functional approach both are treated simply as true security interests.<sup>217</sup> But in this case it was necessary to distinguish the two arrangements for purposes of taxation. The circumstances of the case indicated that under the Canadian Income Tax Code, the otherwise taxable payment which was due to a secured creditor should have been paid to the Revenue in priority to any security interest. On the facts of the case, the court decided that since the debtor/seller retained the right to redeem

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<sup>211</sup> McCormack (n 102) 113

<sup>212</sup> Bridge, Macdonald, Simmonds, Walsh (n 108) 580-581.

<sup>213</sup> McCormack (n 8) 121.

<sup>214</sup> R v Alberta (Treasury Branches) (1996) 133 (4<sup>th</sup>) 609 as cited in McCormack (n 8) 121.

<sup>215</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 230.

<sup>216</sup> B Clark, *‘The Law of Secured Transactions under the Uniform Commercial Code’* (Warren, Gorham & Lamont 1993) cited in Bridge, Macdonald, Simmonds, Walsh (n 108) n 64.

<sup>217</sup> McCormack (n 8) 121-123.

the debts, the arrangements could not amount to an absolute assignment and the money was payable to the Revenue.

This case is not the only example when characterisation of security devices may still be relevant under the functional approach. A substantial body of the US case law<sup>218</sup> on distinction of true leases and security interests indicates that the problem of characterisation persists under the functional approach.<sup>219</sup> True leases are governed by Article 2A UCC and need not be perfected or filed under Article 9 as a security interest.<sup>220</sup> If the lessor is in reality a secured creditor which retains a security to ensure performance of the debtor's obligation, Article 9 applies and the secured creditor loses its privileged position unless it complies with its requirements, such as filing of the financing statement.<sup>221</sup> The issue is rather complicated and some commentators have even suggested that both true leases and those leases amounting to the security interests should be subjected to the requirements of filing to eliminate the need of characterisation.<sup>222</sup>

To summarise, Article 9 was once described as the "most modernised, rational and comprehensive system of security interests in the present world".<sup>223</sup> While this may be the case, the functional way of defining security interests seems to have its advantages and disadvantages which may explain why some legal systems chose to retain the formal approach towards the definition of security interests.

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<sup>218</sup> *Leasing Services Corp. v. American Nat. Bank & Trust Co.* 1976 WL 23674, 19 UCC (D.N.J. 1976); *In re Lerch*, 147 B.R. 455, 20 UCC 2<sup>nd</sup> 260 (Bankr. C. D. Ill.1992).

<sup>219</sup> White and Summers (n 33) 716-727.

<sup>220</sup> M Livingston, 'Certainty, Efficiency and Realism: Rights in Collateral under Art 9 of the Uniform Commercial Code' (1994) 73 North Carolina L Rev 115, 125-126.

<sup>221</sup> White and Summers (n 33) 717.

<sup>222</sup> D Baird and T Jackson 'Possession and Ownership: An Examination of the Scope of Art 9' (1983) 35 Stan L Rev 175, 189-194. For the opposite view see C Mooney, 'The Mystery and Myth of 'Ostensible Ownership' and Art 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases' (1988) 39 Alabama L Rev 683.

<sup>223</sup> McCormack (n 102) 141.

## 2.4 Security interests and the concept of the international interest under the Convention

### 2.4.1 General

One of the main objectives of the Convention is to establish an effective international legal framework for the creation, perfection, priority and enforcement of international interests held in the uniquely identifiable high value mobile equipment.<sup>224</sup> The international interest is the key category of interests which are governed by the Convention and its Protocols.<sup>225</sup> In spite of this fact, the Convention does not provide a comprehensive definition of this concept. Instead, its meaning has to be ascertained from Articles 2 and 7 of the Convention.<sup>226</sup> Article 7<sup>227</sup> indicates that an international interest may be created where the agreement for its creation a) is in writing, b) relates to the object of which the chargor, conditional seller or lessor has power to dispose, c) enables the object to be identified in conformity with the Protocol, d) in the case of security agreement, enables the secured obligation to be determined, but without the need to state the maximum sum secured. The international interest must relate to one of the objects of mobile equipment listed in Article 2(3)<sup>228</sup> and be either a) granted by the chargor under a security agreement, b) vested in a person who is the conditional seller under a title reservation agreement, or c) vested in a person who is the lessor under a leasing agreement. Consequently, consensual security interests are treated by the Convention under the umbrella of the international interest along with the interests vested in a conditional seller and lessor.

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<sup>224</sup> See the Preamble of the Cape Town Convention, available at: <<http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>>.

<sup>225</sup> In total, the Convention provides a legal regime for the protection of five distinct types of interests, namely, international interests, prospective international interests, national interests, registrable non-consensual rights or interests arising under national law and non-consensual rights or interests arising under national law and given priority without registration. See Art 16, the Convention.

<sup>226</sup> Art 1 of the Convention defines terms used in it. All provisions of the Convention and Protocols must be read in light of these terms. However, Art 1(o) may be of little assistance in the process of ascertaining the meaning of the concept of international interest since it simply defines international interests as ‘an interest held by a creditor to which Art 2 applies.’

<sup>227</sup> The formal requirements for the constitution of an international interest prescribed by Art 7 will be examined in Chapter II dealing with the issues of creation of security interests.

<sup>228</sup> Art 2(3) lists the following objects: a) airframes, aircraft engines, helicopters; b) railway rolling stock; c) space assets. The relevant Protocols provide complete means of identification of such objects for the purposes of the Convention.

#### 2.4.2 International interest and national law

The international interest created under the Convention exists independently of domestic law and is governed exclusively by its provisions.<sup>229</sup> Provided that the interest was created in accordance with Articles 2 and 7 of the Convention, it will constitute a valid international interest even if it would not have had such an effect under national law.<sup>230</sup> For instance, a written security agreement, designed to ensure repayment of a loan secured by an aircraft engine identified in conformity with the Aircraft Protocol and in relation to which the chargor has the power to dispose, will constitute a valid international interest even if under the applicable domestic law it would have been void for lack of registration, notarial certificate or statement of the precise amount of the loan advanced to the debtor.

Likewise, an interest validly created under domestic law will not constitute an international interest unless it complies with the requirements of the Convention.<sup>231</sup> If the formal requirements for the creation of international and purely national interests coincide, they may come into existence simultaneously and the creditor may exercise the rights given to it by domestic law as long as they do not conflict with the provisions of the Convention.<sup>232</sup> At the same time, a registered international interest may give the secured creditor stronger rights since it will accord it a priority over domestic interest, as well as subsequently registered and unregistered interests and will survive debtor's insolvency.<sup>233</sup>

#### 2.4.3 The problems of definition of the international interest

The above overview of the concept of the international interest shows that the Convention does not provide a comprehensive definition in a sense that it does not specify the properties or characteristic features which can enable one to capture its meaning. Instead, Article 2 offers, an extensional definition whereby the meaning of the concept of the international interest is ascertained by specifying its extensions, namely all, so to speak, members of the set, i.e. types of interests that

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<sup>229</sup> Goode, Commentary (n 38) 175.

<sup>230</sup> Goode, Kronke, McKendrick (n 65) 441.

<sup>231</sup> R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) 15 Bond L Rev 9, 12.

<sup>232</sup> Goode, Commentary (n 38) 175.

<sup>233</sup> Goode, Kronke, McKendrick (n 65) 441.

fall into its category and can help one understand what the concept of international interest entails. Leaving the formal requirements aside, the meaning of the concept of the international interest is primarily ascertained by reference to one of the categories of interests contained in Article 2(2), namely a) a security agreement, b) a title reservation agreement, or c) a leasing agreement. In order to define the concept of the international interest,<sup>234</sup> one should decide whether, provided all other formal requirements of Article 7 are met, a transaction under which a contracting party seeks to establish an international interest with respect to one of the objects listed in Article 2(3) may be characterised as either a security, title reservation or a leasing agreement. This means that the definition of the international interest implies that one knows what do security, title reservation and lease mean in the first place. In this respect the following question may arise. When one attempts to define the international interest by reference either to security, title reservation or lease, how is one to determine whether a transaction in question amounts to one of such interests? Should the answer be found in the Convention itself or in the applicable domestic law? This question will be addressed below.

#### 2.4.4 Defining international interest by reference to the categories of interests in Article 2(2): applicable law or the Convention?

Article 2(4) stipulates that ‘the applicable law determines whether an interest to which paragraph 2 applies falls within sub-paragraph (a), (b) or (c) of that paragraph.’ The applicable law is said to refer to the ‘domestic law of the State whose law is applicable by the rules of private international law of the forum’.<sup>235</sup> This means that the applicable domestic law, and not the Convention, decides whether a transaction in question amounts to a security agreement, title reservation or a leasing agreement, but the issues relating to their ‘effects’, such as

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<sup>234</sup> The issue of the definition of the international interest may be relevant for the purposes of establishing whether a transaction in question should be governed by the Convention. In order for the Convention to apply not only the international interest must be validly concluded, but other requirements on applicability must also be met. According to Art 3, the debtor must be situated in a Contracting State at the time of the conclusion of the agreement for the creation of the international interest.

<sup>235</sup> Art 5(3), the Convention.

registration, priority and enforcement,<sup>236</sup> are governed by the Convention.<sup>237</sup> At the same time, Article 1 provides a list of definitions which are used throughout the Convention, including such terms as ‘security agreement’,<sup>238</sup> ‘title reservation agreement’,<sup>239</sup> and ‘leasing agreement’.<sup>240</sup> The Convention and its Protocols must be read in accordance with these definitions.<sup>241</sup> It is not clear why the Convention defines these interests if it delegates the issue of their characterisation to the applicable law. In other words, if it is for the applicable law to characterise or define whether a transaction in question amounts to a security, reservation of title or a leasing agreement, what is the role of the definitions of these terms provided by Article 1? It appears that the Convention provides for two different routes of defining security, title reservation and lease under Articles 1 and 2(2) and does not clearly explain how one route relates to the other. The following sections will explore each route of defining the creditor’s interests and attempt to ascertain their relation to each other under the Convention.

a) The reasons why characterisation of transactions was left to the applicable domestic law and the possible consequences of such an approach

The uniform characterisation of the interests which fall into Article 2(2) would make the understanding of the international interest relatively easier since the meaning of each interest could be ascertained on a uniform basis. However, Article 2(4) indicates that the applicable domestic law should determine whether a transaction in question amounts to security, title reservation or a lease. The Chairman of the Drafting Committee of the Convention indicated that a uniform approach on the characterisation of security interests, title reservation and lease

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<sup>236</sup> Art 2(1) indicates that the Convention provides for the constitution and effects of an international interest in certain categories of mobile equipment and associated rights. In its Comments to the Draft Convention presented to the Commission, representatives of Kuwait proposed to delete the word “effect” as having no significance on the proposition that the text of the Convention would be clearer without it. This suggestion was not followed and the Official Commentary defines “effects” as the term which denotes default remedies, perfection and priority requirements, as well as effectiveness in the debtor’s insolvency. For the propositions of Kuwait see Diplomatic Conference to Adopt a Mobile Equipment Convention and an Aircraft Protocol: Acts and Proceedings, DCME Doc No. 20 (C), 157, (UNIDROIT, Rome 2006). For the commentary on the term “effects” see Goode, Commentary (n 38) 168.

<sup>237</sup> Goode, Kronke, McKendrick (n 65) 449.

<sup>238</sup> Art 1(ii), the Convention.

<sup>239</sup> Art 1(II), the Convention.

<sup>240</sup> Art 1 (q), the Convention.

<sup>241</sup> Goode, Commentary (n 38) 154.

under the Convention was impracticable in view of the sharp divide between formal and functional approaches adopted by various legal systems in relation to the definition of security interests and other similar devices.<sup>242</sup> The two approaches co-exist in today's world of security interest and it was necessary to address this issue in the process of drafting of the Convention since it affects what may or may not be treated as a security interest, title reservation or a lease. At the stages leading to the draft of the Convention, the sub-committee of the Study Group responsible for the preparation of uniform rules on security interests concluded, among other things, that the Convention should adopt the functional approach to the definition of security interests embracing the notions of the reservation of title and lease.<sup>243</sup> This was also in line with the proposals of Professor Cuming expressed in his Report<sup>244</sup> and was confirmed by the positive response to the Questionnaire on the issues of security interests distributed among banks, financial institutions, buyers and sellers.<sup>245</sup> However, some legal systems, adhering to the formal approach, as well as the representatives of the European Leasing Industry, insisted on retention of the distinction between traditional security interests and retention of title and lease.<sup>246</sup> In these circumstances the uniform characterisation of interests seemed impracticable and it was decided to leave the question of characterisation to the applicable law.<sup>247</sup> Because, as the example provided below illustrates, similar transactions are sometimes labelled differently by various legal systems, the approach adopted by the Convention with respect to characterisation may result in the same transaction being treated either under category a), b), or c) of Article 2(2). The difference between these categories is primarily relevant to the issue of remedies which may be exercised by the creditor.<sup>248</sup>

Consider an agreement for the sale of an airframe concluded between a seller located in a Contracting State which follows the formal approach and a buyer situated in a Contracting State adhering to the functional approach.<sup>249</sup> Under

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<sup>242</sup> Goode, Commentary (n 38) 169.

<sup>243</sup> Davies (n 198) 161.

<sup>244</sup> R Cuming, 'International Regulation of Aspects of Security Interests in Mobile Equipment' UNIDROIT 1989, Study LXXII Doc 2.

<sup>245</sup> Davies (n 198) 158-159.

<sup>246</sup> Ibid 161.

<sup>247</sup> Goode, Commentary (n 38) 169.

<sup>248</sup> Art 8, 9, 10, the Convention.

<sup>249</sup> See Goode, Commentary (n 38) 169 for a similar example.



this agreement, the seller is allowed to retain ownership in the airframe until it receives a purchase price from the buyer. On default by the buyer, the seller wishes to return possession of the airframe. Assuming that the Convention applies and that the applicable law is that of the seller's jurisdiction, the arrangement will be characterised as the retention of title agreement. In contrast, if the applicable law is that of the buyer's jurisdiction, the arrangement will be characterised as a security agreement. In the case of the former, the seller will be able to exercise the remedies available to it under Article 10 of the Convention as the true owner of the property. In case of the latter, the seller will be able to exercise the remedies available to it under Articles 8 and 9 of the Convention as a secured creditor.

One of the advantages of the delegation of the issue of characterisation to the applicable domestic law is that it allows the Convention to stay outside of the long standing debate between the formal and functional approaches which persists in some legal systems. The delegation of this issue may represent a compromise solution expressly providing Contracting States with options, allowing them to decide which of the two approaches they prefer.<sup>250</sup> The fact that Article 2(2) expressly distinguishes between a) security agreement, b) title reservation and c) leasing agreements indicates that those legal systems which still adhere to the formal distinctions between true and quasi security interests can use any of these categories in order to introduce the transaction in question into the bigger category of the international interest under Article 2 of the Convention.<sup>251</sup> At the same time, true security and quasi security interests may be subsumed under category a) of Article 2(2) as a 'security agreement', should the applicable domestic law adhere to the functional approach.<sup>252</sup> On this view, the categorisation of transactions into a) security agreement, b) reservation of title and c) leasing agreements under the umbrella of the international interest allows both formal and functional approaches to co-exist at the stage of defining the international interest, but, as will become clear later, not merge into one.

To clarify, Article 2(4) allows the Convention to avoid being involved into the formal v functional debate. Instead, the Convention accepts various

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<sup>250</sup> See R Goode, 'Rule, Practice, and Pragmatism in International Commercial Law' (2005) ICLQ 539, 560 in which the author indicates that for an international convention to be successful a right balance needs to be struck between different interests.

<sup>251</sup> B Honnebler, 'The New International Regimen by UNIDROIT as a Means of Safeguarding Rights In Rem of the Holder of an Aircraft under Netherlands Law' (2001) 6 Unif L Rev 5, 17-22.

<sup>252</sup> Ibid 17-22.

transactions under the labels attached to them by domestic laws (as long as they fall into one of the categories of Article 2(2)) into the bigger category of the international interest. United under the category of the international interest, all three types of interests are then subjected to the uniform legal regime of the Convention governing creation, registration and priority of these interests. In other words, at the stages of creation, registration and priority, the differences between the three types of the transactions do not appear to be relevant and all three are simply treated as ‘international interests’.<sup>253</sup> Once the international interest has been defined and constituted, the distinctions between the three categories under the umbrella of the international interest do not, however, become wholly irrelevant under the Convention.<sup>254</sup> When the issue of the remedies arise, the characterisation of the transaction once again becomes important.<sup>255</sup> This is so because, while a secured creditor may exercise remedies available to it under Articles 8 and 9, a conditional seller and lessor may only trigger the remedies available to them under Article 10 of the Convention.<sup>256</sup> The remedies under Articles 8 and 9 are more detailed than those under Article 10 because a secured creditor, unlike a conditional seller and lessor, is not considered to be an absolute owner of the object.<sup>257</sup> It should be noted that in those countries which follow the functional approach, reservation of title and some leases are treated as security interests.<sup>258</sup> When the transaction is characterised by the domestic law of one of such countries, the creditor will only be able to exercise the remedies available to it as a secured creditor, and not as the conditional seller or lessor.<sup>259</sup> In order to ensure that the same transaction is not characterised by the applicable domestic law as the parties think fit, Article 2(2) provides that categories enumerated therein are mutually exclusive. This means that once a transaction has been characterised as, for instance, a title reservation agreement it cannot be later re-characterised as a security interest.<sup>260</sup>

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<sup>253</sup> For instance, Art 16(1)(a) of the Convention which enumerates the types of registrable interests does not distinguish between security, title reservation and lease and defines them as ‘international interests.’

<sup>254</sup> Honnebier (n 251) 23.

<sup>255</sup> Ibid 23.

<sup>256</sup> Goode, Commentary (n 38) 169.

<sup>257</sup> Ibid 187.

<sup>258</sup> Ibid 169.

<sup>259</sup> Ibid 170.

<sup>260</sup> Honnebier (n 251) 23.

Although Article 2(4) of the Convention allows both functional and formal approaches to co-exist under the umbrella of the international interest, it seems that characterisation of interests by reference to domestic law may encourage contracting parties to seek for a jurisdiction under which their agreement will be characterised in the way which may suit their interests best. For instance, a conditional seller who would be treated as a secured creditor under the functional approach may wish its interest to be characterised as a ‘reservation of title’ as would be the case under the formal approach. This position may be more advantageous to such a conditional seller, since Article 10 allows it to ‘terminate the contract and take possession or control of any object to which the agreement relates’. By contrast, Article 8 only allows a secured creditor to take possession and sell or lease the collateral ‘to the extent that the debtor has at any time so agreed.’

b) Article 1(q), (ii), (ll) and Article 2(4): the two routes of defining

If the interests listed in Article 2(2) are characterised by domestic law under Article 2(4) and the creditor exercises the remedies depending on the national characterisation of its interest, the definitions of security, title retention and lease provided in Article 1 may not be needed at all. If this is the case, what is the role of the definitions contained in Article 1(q), (ii) and (ll)?

The Convention does not appear to provide a clear answer to this question. Some commentators<sup>261</sup> suggest that ‘it is for the applicable law to determine into which of the three categories of agreement referred to in Article 2(2) a particular agreement falls, though the meaning of *‘security agreement,’ ‘title reservation agreement’ and ‘leasing agreement’ is determined by Article 1, not national law’*.<sup>262</sup> But once the transaction is characterised by domestic law, what is the purpose of defining it again in accordance with Article 1? Moreover, it appears that the characterisation of security, title retention and lease under the applicable law and definitions of such transactions found in Article 1 may not always coincide. Consider an agreement whereby the owner (the creditor) is letting the aircraft on hire to the hirer (the debtor) in return for payment of the rentals, the

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<sup>261</sup> Goode, Kronke, McKendrick (n 65) 449.

<sup>262</sup> Emphasis added by the author.

latter having an option to purchase the aircraft, and that other requirements of Articles 2 and 7 are met. Such an agreement will have to be characterised or defined in order to establish the international interest to which the Convention can apply. If, Article 2(4) is relied upon and for instance, English law applies, the agreement may be characterised as hire purchase and will not fall into either of the categories of Article 2(2). In contrast, if Article 1(q) is applied in defining the agreement, it may fall into the category c), namely ‘a leasing agreement’ and for this reason will be governed by the Convention as an international interest. English law distinguishes lease and hire purchase on the basis that while the lease does not entail an option to purchase and the property must be returned to the lessor at the end of the agreement, hire purchase provides the hirer with such an option.<sup>263</sup> For this reason, under English law, hire purchase and lease are treated differently by law and do not constitute the same thing.<sup>264</sup> In contrast, the broad definition of leasing agreement provided by Article 1(q) includes any agreement by which ‘one person (the lessor) grants a right to possession or control of an object (with or without option to purchase) to another person (the lessee) in return for a rental...’. This broad definition would capture the agreement in the above example and define it as a lease.

This example illustrates that the Convention appears to provide two different routes for defining security interest, title reservation and leasing agreement and does not clearly explain the nature of the relationship between them. The confusion caused by this uncertainty may further be demonstrated by the comment with respect to the definition of leasing under Article 1(q) made in the Official Commentary to the Convention. It reads as follows: ‘leasing agreement...covers leases and sub-leases with or without option to purchase...whether or not the transaction would be characterised by national law as a leasing agreement, though under Article 2(4) it is left to the applicable law to determine whether the agreement is to be characterised as a leasing agreement or *a security*...’.<sup>265</sup> With respect, this comment does not seem to explain which of the two routes shall be followed when the transaction is characterised.

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<sup>263</sup> At the same time the distinction between hire purchase and lease may become less clear if, as is often the case, the lessee is given the right to receive any proceeds of sale of the goods at the end of the lease. See Beale, Bridge, Gullifer, Lomnicka (n 13) 204-205.

<sup>264</sup> Ibid 204.

<sup>265</sup> Goode, Commentary (n 38) 161. Emphasis added by the author.

The treatment of the leases under Articles 2A and 9 of the United States Uniform Commercial Code may also highlight that the two routes of defining such agreements under the Convention might lead to different outcomes. Article 1(q) of the Convention and the Official Commentary state that the leasing agreement covers ‘...any agreement by which one person grants to another a right to possession or control of an object in return for a rental...’.<sup>266</sup> The UCC distinguishes between true leases which are governed by Article 2A and leases which are characterised as security interests and are governed by Article 9.<sup>267</sup> In case a transaction in question is characterised by Article 2(4) and the US law applies, it may allocate the transaction in question into either category a) ‘security agreement’ or c) ‘leasing agreement’ listed under Article 2(2). This will undoubtedly be important for the parties because each category under Article 2(2) triggers different remedies. On the contrary, if Article 1(q) is relied upon to define the transaction in question, it will treat it simply as a lease provided that it is an agreement by which possession is transferred by one party to the other in return for the rental payments.

#### c) A suggested explanation

As previous sections suggest, the Convention provides for two ways of finding out whether a transaction in question falls into one of the categories of Article 2(2). First, Article 2(4) states that the transaction must be characterised as either a security, title reservation or a leasing agreement in accordance with the applicable domestic law. Second, the terms security, title reservation and lease are defined by Article 1 of the Convention. The Convention does not appear to provide a clear answer as to the relationship between these Articles. It is difficult to reconcile the two mechanisms as they appear to contradict one another. Article 2(4) leaves the question of characterisation outside of the scope of the Convention and provides that relevant legal systems should deal with this issue. At the same time, Article 1 defines security, title reservation and leases for the purposes of the Convention. If contracting parties define these terms in accordance with Article 1, this may provide them with a uniform characterisation of such interests for the purposes of

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<sup>266</sup> Ibid 161.

<sup>267</sup> White and Summers (n 33) 716-719.

the Convention. Since the two approaches head in opposite directions, it is difficult to find a way of reconciling them. It should be noted that Article 2(4) states that the applicable law should determine whether an interest is a security interest, a title reservation or a lease. This provision clearly indicates that the Convention should not be used for the purposes of characterisation of a transaction in order to establish the international interest. The fact that the drafters of the Convention did not intend it to be used for this purpose also flows from Article 2(4) of the Draft Convention, which reads as follows: ‘The Convention does not determine whether an interest to which paragraph 2 applies falls within sub-paragraph (a), (b) or (c)...’.<sup>268</sup> This wording shows that under no circumstances should definitions of security, title retention and lease contained in Article 1 be used in order to decide whether a transaction in question falls into one of the categories of Article 2(2). The fact that the drafters of the Convention intended the applicable domestic law, and not the Convention, to characterise the transaction is also evident from the comments to the Draft Convention presented by Japan.<sup>269</sup> The comments state that: ‘since the characterisation is always the first step to determine the applicability of relevant provisions, i.e. the remedies under the Convention, and thus, this paragraph seems to be so important to be argued and interpreted repeatedly by the relevant parties in future, the explicit provision [that it should be governed by the applicable law and not the Convention] is preferable to avoid future confusions and misunderstandings.’ Finally, Article 1 which defines terms used in the Convention provides that these definitions should only be used as long as the context of the Convention does not require otherwise. For this reason, it seems that Article 2(4) should be given priority over the definitions of security, title retention and lease provided by Article 1 for the purpose of characterisation of the transaction in question. If this is the case, what is the role of these definitions under the Convention? One explanation of the relationship between two alternatives of defining a transaction may be that the definitions under the Convention are only relevant for the initial

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<sup>268</sup> Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment: Diplomatic Conference to Adopt a Mobile Equipment Convention and an Aircraft Protocol - Acts and Proceedings, Draft [UNIDROIT] Convention on International Interests in Mobile Equipment, DCME Doc No. 3. 6/4/01. Emphasis added by the author.

<sup>269</sup> Ibid, 186. DCME Doc No. 32; 31/10/01.

characterisation.<sup>270</sup> On this view, the definitions of Article 1(q), (ii) and (ll) should be applied to determine whether a transaction in question gives rise to an interest which, in principle, can be governed by the Convention.<sup>271</sup> If, applying the definitions in Article 1, a creditor's interest can be defined as that of a secured creditor, conditional buyer or the lessor, this interest should be governed by the Convention.<sup>272</sup> Once this is established, then the transaction should be characterised by the applicable domestic law for the purpose of other provisions of the Convention and, in particular, those, relating to the remedies available to the creditor under the Convention and the Protocols.<sup>273</sup> Although this is the explanation which is currently accepted under the Official Commentary, it may not be entirely satisfactory. The definitions of the creditor's interest may not always coincide under the Convention and the applicable domestic law. As indicated above, a transaction which may be characterised as a lease under the Convention (for the purpose of deciding whether the creditor's interest arising under this transaction may constitute an international interest) may be later re-characterised as a hire-purchase agreement by the applicable domestic law. In this case it may not be clear whether such interest should be governed by the Convention. If re-characterisation occurs at a time when the creditor needs to exercise the remedies under the Convention it may not be clear to which remedies if any it may be entitled to. In addition, this approach may cause confusion to the parties involved if, for instance, the creditor's interest is initially characterised by the Convention as that of the secured creditor only to be later re-characterised by the applicable domestic law as that of the lessor.

Alternatively, it may be argued that while characterisation under applicable domestic law is relevant for the purpose of defining whether a transaction in question falls into one of the categories of Article 2(2) as well as for the purpose of deciding which remedies may be exercised by the parties, the meaning of these terms, whenever they are used in other provisions of the Convention, should be read in accordance with Article 1. This approach is different to the one accepted under the Official Commentary in that the definitions under Article 1 are not used for the initial characterisation of the creditor's interest. Instead, the interest is

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<sup>270</sup> Goode, Commentary (n 38) 168.

<sup>271</sup> Ibid 169.

<sup>272</sup> Ibid 169.

<sup>273</sup> Ibid 169.

characterised by the applicable domestic law as prescribed by Article 2(4). Once the interest is characterised, it can be established whether it should be governed by the Convention. Under this explanation, the interest of the owner under a hire-purchase agreement in the above example would not be covered by the Convention. This approach can also eliminate the possibility of re-characterisation of the creditor's interest at some later stage. This, in turn, may bring predictability to the creditor in relation to the remedies which it can invoke. Once the interest is characterised by the applicable domestic law, it is subjected to the legal regime of the Convention and the definitions provided in Article 1. This means that, in relation to other provisions of the Convention, such as the rules on priority and registration, the creditor's interest should be defined in accordance with Article 1. For example, if the creditor's interest is characterised by the applicable domestic law as that of the conditional seller, this does not mean that such interest need not be registered and should be granted super-priority simply because the creditor is considered as owner of the object even if this would be a natural connotation of its characterisation under the applicable law. The role of the applicable law ceases once the creditor's interest is characterised as that of the conditional seller. After that it should be considered in accordance with the definitions provided under Article 1. This means that the conditional seller will not be granted super-priority and that it will have to register its interest in the International Registry in order to secure its priority against subsequently registered and unregistered interests.

### 3. The legal nature of security and international interests under the Convention

#### 3.1 General

Consider the following situation. A financier is willing to make a loan to the borrower for the purpose of the manufacture of a new satellite which the borrower intends to add to its satellite constellation. In order to assure the financier that the loan and interest will be repaid, the borrower transfers ownership in the satellite which is being constructed to the financier for the duration of the loan. The parties agree that once the debt is discharged, ownership in the satellite will revert back to the borrower. The satellite is intended to be operated at low Earth orbit and thus out of reach of any jurisdiction known to the financier. Concerned about possible



practical complications which location of the collateral may entail for the purposes of taking possession or sale of the satellite in case of the borrower's default, the financier may wish to support its security by some other means.<sup>274</sup> To achieve this objective, the directors of the borrower company are willing to provide the financier with personal guarantees whereby they undertake to repay borrowed sums together with interest, should the borrower default on its payments.

Both arrangements are entered into with the sole intention to assure the financier that the borrowed sums and interest will be repaid in due course. For this reason, some jurisdictions treat such arrangements simply as different types of security interests. For instance, the Russian Civil Code considers personal guarantees simply as one of the means of securing performance of an obligation and treats them alongside other forms of security, such as a hypothec over movable and immovable property, a pledge, a right of retention and others.<sup>275</sup> Other legal systems take the view that the legal nature of these two arrangements is so different that it is necessary to treat them almost as different institutions of law.<sup>276</sup>

The arrangement between the financier and the borrower provides the former with a proprietary interest in the property of the latter and is often referred to as a real security.<sup>277</sup> By obtaining ownership in the satellite as a means of securing repayment of the debt, the financier obtains an interest in the property itself. Because it is an interest in the property and not simply a right against a particular contracting party with respect to the property, the financier will, in theory, be able to pursue the satellite into the hands of a third party (with whom the financier has no contractual relationship), should the borrower sell it and

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<sup>274</sup> Since satellites are not usually located on Earth, the potential secured creditor may be concerned that on the debtor's default repossession of the collateral may prove impossible. To alleviate this practical complication some commentators suggest that the notion of space property under the Convention should be widened in order to include other means of control over space objects. It is suggested that the notion of space property should, among other things, include intangible rights which may enable a secured creditor to control, operate and dispose of the space property and proceeds deriving out of the operation of satellites. D Panahy and R Mittal, 'The Prospective UNIDROIT Convention on International Interests in Mobile Equipment as Applied to Space Property' (1999) 4 Unif L Rev 303, 306.

<sup>275</sup> The Civil Code of the Russian Federation, Part One, 30.11.1994, N 51- Φ3. See Chapter 23, in particular Article 329, Articles 361-367 of the Civil Code. The Russian version of the Civil Code is available at: <<http://www.9111.ru/materials/?dop=197>>.

<sup>276</sup> Gullifer (n 14) 1-17.

<sup>277</sup> For a difference between property and personal rights see R Goode, 'Ownership and Obligation in Commercial Transactions' (1987) LQR 433, 433-434.

dissipate the proceeds of sale.<sup>278</sup> By earmarking or appropriating this particular satellite to the discharge of the debt, the financier may also ensure that, in the case of the borrower's insolvency it will be able to obtain repayment by means of realising its security in priority to the borrower's other creditors.<sup>279</sup> The property encumbered by real security of the financier will no longer be available for distribution among the insolvent borrower's unsecured creditors.<sup>280</sup> Generally speaking, the financier holding real security in the borrower's property will be able to segregate or take this property out of the insolvent borrower's estate in order to sell it (or deal with it by other acceptable means) and use the proceeds towards discharge of unpaid debt.<sup>281</sup>

In contrast, the arrangement between the financier and the directors with respect to personal guarantee confers no such powers on the financier.<sup>282</sup> Similar to the real security, a personal guarantee affords the financier additional security in that it may rely on the directors for repayment of the debt should the borrower default on payments.<sup>283</sup> However, a personal guarantee whereby the guarantor undertakes to honour the obligation owed to the financier by the borrower is a mere contractual obligation and confers no proprietary interest in the property of the directors on the financier.<sup>284</sup> For this reason such a security is often called a personal security as opposed to the real one.<sup>285</sup> If the satellite mistakenly smashes into the surface of Mars and is completely destroyed as a consequence of collision at the time when the borrower has filed for insolvency, the financier's security may be in jeopardy. In these circumstances, the financier may wish to turn to the directors in the hope of obtaining discharge of the borrower's debt. If the directors are able to honour the guarantee, all is well. On the other hand, if the financier learns that the directors are also bankrupts, it will have to join the queue of their other creditors in the hope of obtaining at least some repayment of borrowed

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<sup>278</sup> The ability of the holder of a property right to pursue or trace the asset into the hands of a third party is considered as one of the incidents of such a right. See McKendrick (n 2) 664.

<sup>279</sup> R Goode, *Proprietary Rights and Insolvency in Sales Transactions*, 2<sup>nd</sup> edn (London, Sweet & Maxwell 1989) 2.

<sup>280</sup> J Dalhuisen, 'Security in Movable and Intangible Property. Finance Sales, Future Interests and Trusts' in A S Hartkamp (ed), *Towards a European Civil Code*, 3<sup>rd</sup> edn (New York, Kluwer Law International 2004) 363.

<sup>281</sup> Goode (n 279) 2-3.

<sup>282</sup> А Сергеев, Ю Толстой (Ред), *Гражданское Право*, Ч 1, стр. 586. (A Sergeev and Y Tolstoy (eds) 'Civil Law', Part 1, 586).

<sup>283</sup> Ibid 586.

<sup>284</sup> Ibid 586.

<sup>285</sup> Ali (n 32) 176.

sums. Because the personal guarantee did not confer any interest in the property of the directors to the financier, the financier will not be able to take possession and sell any property in which the directors have interest in order to discharge the obligation prior to its other creditors.

Assuming that the Convention applies to this example and that Russian law is the applicable domestic law which is used for characterising the two agreements, can the financier claim that both its agreements with the borrower and the directors should be treated as security under the Convention? In other words, can it be argued that any arrangement which is called a security interest under applicable domestic law can be treated as the international interest?<sup>286</sup> Article 2(4) states that the applicable domestic law should characterise agreements either as security, title retention or lease which necessarily implies that the Convention has no role to play in this exercise. On this view both agreements should be treated as the international interests. On the other hand, the provisions of the Convention can be said to reveal the legal nature or the essence of international interests which it intends to govern. As the following sections will attempt to demonstrate the Convention aims to govern international interests of proprietary rather than personal nature. The agreement between the financier and the directors is clearly of a personal nature in that it confers no interest in the property of the latter to the former. When the nature of an international interest and the essence of the agreement which has been characterised as security by domestic law do not coincide, should the notion of international interest nevertheless be stretched as far as to cover such an agreement? It can be inferred from a number of Convention's provisions that only interests which are of proprietary nature are understood as international interests under the Convention. It follows that, although the Convention does not state so expressly, proprietary nature of an interest is a necessary criterion to be met in order for it to fall within the Convention's scope.

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<sup>286</sup> Art 2(2) of the Convention provides that 'an international interest in mobile equipment is an interest, constituted under Article 7, in a uniquely identifiable object of a category of such objects listed in paragraph 3 and designated in the Protocol: a) granted by the chargor under a security agreement; b) vested in a person who is the conditional seller under a title reservation agreement; or c) vested in a person who is the lessor under a leasing agreement.'

### 3.2 The natural filter: uniquely identifiable mobile equipment

The broad definition of a security interest under the Convention may suggest that, provided that other requirements of its applicability are met, any arrangement which can be characterised as security under the applicable domestic law may be treated as international interest. On the other hand, the Preamble of the Convention indicates that its main objective is to facilitate asset-based finance and leasing of mobile equipment by providing an international regime for the regulation of interests in such equipment. The provisions of the Convention put a strong emphasis on the need for international interests, including security interests, to be connected with a unique item of mobile equipment.<sup>287</sup> Article 1(ii) defines a security agreement as ‘an agreement by which a chargor grants...to a chargee...an interest...in or over an object to secure the performance of any existing or future obligation...’. Similarly, Article 1(II) on title retention refers to the reservation of ownership in an object which is not to pass until fulfilment of certain conditions. Article 1(q) on lease allows a lessor to grant a lessee possession or control of an object in return for rental payments. Finally, Article 2 ties the notion of international interest with uniquely identifiable assets and specifically enumerates categories of types of objects in which contracting parties may have such interest.<sup>288</sup> Since the agreement on personal guarantee between the financier and the directors in the above hypothetical situation does not confer on the former any rights or interests in the asset of the latter, let alone asset of such type as is indicated in Article 2(3) of the Convention, it is highly unlikely that the financier will be able to establish that this agreement should be characterised as security for the purposes of the Convention. The need for international interest, including a security interest, to be focused on a specific object seems to serve as a natural filter designed to keep the arrangements which may provide security, but

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<sup>287</sup> Honnebier (n 39) 6.

<sup>288</sup> Art 2(3) of the Convention lists the categories of equipment in which international interest may arise. Such types of equipment currently include a) airframes, aircraft engines and helicopters; b) railway rolling stock; and c) space objects. Aircraft and other aircraft objects are defined in more detail in Art I(2)(a), (b), (c) and (e) of the Aircraft Protocol. Similarly, Art 1(e) of the Luxembourg Protocol provides a more detailed definition of railway objects. The categories listed in Art 2(3) are not conclusive and can be added to by other types of mobile equipment in future. Art 51 of the Convention allows such extension by granting the Depositary the power to create new working groups. The purpose of such working groups will be to assess the feasibility of extending application of the Convention to other objects and to draft new Protocols.

do not meet this requirement out of its legal framework. This means that such forms of security under the Russian Civil Code as the forfeit or liquidated damages is also likely to be excluded from the ambit of the Convention. The forfeit is a form of security whereby the debtor is required to pay to the creditor an agreed sum of money in case of non-performance or inadequate performance of the secured obligation.<sup>289</sup> By means of the forfeit the creditor may ensure that even if secured obligation is not performed, it will still receive the agreed amount of money.<sup>290</sup> Both forms of security are based on the contractual obligation to either secure the performance of the obligation of a third party (the personal guarantee) or to pay the agreed sum of money in case of failure to perform the main obligation (the forfeit). Neither of these forms of security confers any interest in the debtor's property to the creditor by way of security.<sup>291</sup>

To clarify, the mere fact that an agreement in question can be characterised as a true security under the applicable domestic law, does not automatically entail that it can be treated as such under the Convention. To constitute an international interest, such an agreement must confer some interest in a particular asset of the debtor to the creditor by way of security. This also means that such devices as negative pledge and set-off which may perform the function of security, but do not confer any rights in the property of the debtor to the creditor will not be recognised as international interests under the Convention.<sup>292</sup> Negative pledge is, generally speaking, an agreement whereby, in return for the loan, the borrower agrees not to grant a security in its property to anyone else in such a way as to allow this third party to be repaid in priority to the creditor under the negative pledge agreement.<sup>293</sup> One of the aims of the negative pledge is to restrict the ability of the borrower to dispose of its property in an attempt to prevent the shrinking of its pool of assets which could potentially be used as a source of repayment of the debt owed to the creditor.<sup>294</sup> Negative pledge is not usually tied

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<sup>289</sup> Sergeev and Tolstoy (n 282) 586.

<sup>290</sup> Ibid 586.

<sup>291</sup> Ibid 586.

<sup>292</sup> This reflects the position under English law which considers all forms of true security over an asset as proprietary in nature, leaving such arrangements as negative pledges, set-offs, flawed assets and others outside the realm of real security. See R Goode, 'Security: A Pragmatic Conceptualist's Response' (1989) 15 Monash U L Rev 361, 362; Ali (n 32) Chapter 6.

<sup>293</sup> Arkins (n 186) 198.

<sup>294</sup> This is not the only objective of the negative pledge. It is also often incorporated into a security agreement in order to create an event of default, the occurrence of which may trigger the enforcement of true security by the creditor. Arkins (n 186) 199.

to a particular asset of the borrower<sup>295</sup> and consequently is not likely to be covered by the Convention. Similarly, a set-off is a process by which one party can set-off its claim against the claim of the other party.<sup>296</sup> It does not appropriate any property of the debtor to the discharge of the debt and is unlikely to be considered as an international interest under the Convention.<sup>297</sup>

### 3.3 The legal nature of security and international interests: proprietary or contractual?

Even when the debtor grants to the creditor rights over uniquely identifiable mobile equipment as security, one still needs to ascertain the nature of this interest.<sup>298</sup> Does it merely rest in the contract between the creditor and the debtor or is it of proprietary nature? Since contractual and proprietary interests attract different legal consequences, the distinction between them is not purely of academic, but also of considerable practical significance.<sup>299</sup> Many legal systems recognise that a property right implies exclusive dominion over the object which can be asserted against the whole world.<sup>300</sup> Usually, ownership, possession and some or all types of security are considered as forms of property rights.<sup>301</sup> In contrast, a contractual obligation, or a personal right, merely reflects the rights and obligations of contracting parties.<sup>302</sup> In other words, while a property right can be claimed both against the obligor and other third parties, a personal right can

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<sup>295</sup> Gullifer (n 14) 1-74.

<sup>296</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 245.

<sup>297</sup> Under English law, set-off arises by operation of law and can take several forms, namely, common law, equitable and insolvency set-off. In certain cases, the parties may be able to contractually increase or diminish the rights of set-off that would otherwise apply. See *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785.

<sup>298</sup> Gullifer (n 14) 1-17.

<sup>299</sup> McKendrick (n 2) 27-29.

<sup>300</sup> U Mattei, *Basic Principles of Property Law: A Comparative Legal and Economic Introduction* (Contributions in Legal Studies, N 93, Greenwood Press 2000) 78-79.

<sup>301</sup> McKendrick (n 2) 28. English law considers all forms of true security, namely pledge, lien, charge and mortgage as property rights or rights in rem. Since ownership and possession are also forms of property rights, retention of ownership until the fulfilment of stated conditions under conditional sale agreements as well as retention of title under hire-purchase and lease are also treated as forms of property rights. At the same time, some legal systems consider some of the forms of security as proprietary, while other forms as purely personal. The examples from Russian law presented above illustrate this point.

<sup>302</sup> McKendrick (n 2) 29.

only be asserted against the obligor, since, generally speaking, contracting parties cannot impose burdens on the third parties who are not privy to their contract.<sup>303</sup>

A brief example may illustrate the difference between property and personal interests. Consider a leasing agreement between an aircraft manufacturer and an airline under which the lessor/manufacturer delivers possession of an aircraft to the lessee/airline in return for rental payments. The nature of the interest acquired by the lessee in the aircraft will be of crucial importance to it if the lessor decides to sell the aircraft while the lease is still running. If the interest of the lessee is of proprietary nature, the lessee can assert it against the new owner and continue to use the aircraft provided that it pays the rentals without the need to enter into a new contract with the new lessor.<sup>304</sup> The property right is so durable that even if the new owner becomes insolvent, the lessee will be entitled to retain possession of the aircraft for the duration of the lease.<sup>305</sup> If, on the other hand, the interest of the lessee in the aircraft is merely personal and is only valid between itself and the original lessor, the new owner can disregard the lease and demand the lessee to deliver possession of its property back.

The general understanding that property rights should be respected by the world at large can be resorted to in order to explain their major incident: in principle, property rights remain valid in the case of the debtor's insolvency.<sup>306</sup> Some commentators even state that but for the possibility of insolvency, the difference between personal and property rights would be of little significance to the parties concerned.<sup>307</sup> Such a conclusion flows from a widely recognised principle of insolvency law according to which only those assets which belong to the insolvent company are available for distribution among its creditors.<sup>308</sup> If the creditor can demonstrate that it has a property and not simply personal right in an

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<sup>303</sup> S Panesar, *General Principles of Property Law* (Pearson Education 2001) 219.

<sup>304</sup> As was previously mentioned, lease involves retention of title (ownership) in the asset by the lessor and delivery of its possession to the lessee. Since the lessor retains ownership, its interest is of proprietary rather than personal nature. M Bridge, *Personal Property Law*, 3<sup>rd</sup> edn (Oxford, OUP 2002) 27. The proprietary nature of lease in the context of the Convention is also evident from Art 9(4) which states, among other things, that if a debtor uses its right of redemption of charged property and such property was leased by secured creditor before the discharge, the debtor can only exercise its right of discharge subject to the existing lease. This means that the interest of the lessee can be exercised against a third party (the debtor) which demonstrates its proprietary rather than contractual nature.

<sup>305</sup> McKendrick (n 2) 29.

<sup>306</sup> Ibid 28.

<sup>307</sup> Goode (n 279) 2-3.

<sup>308</sup> McKendrick (n 2) 619.

identifiable asset of the insolvent debtor, such property will no longer be considered as available for distribution among its other creditors.<sup>309</sup> The proprietary right in the asset of the insolvent debtor allows its holder to take this asset out of the debtor's estate for the purpose of obtaining discharge of the debt owed to it.<sup>310</sup> For this reason, the unpaid seller who has validly retained ownership of the goods can, in principle, take them back if the buyer is struck by insolvency.<sup>311</sup> Since the unpaid seller has a property right in the goods until it is paid the purchase price, such goods cannot be treated as the property of the insolvent debtor by its liquidator or trustee in bankruptcy.<sup>312</sup> Similarly, if the secured creditor holds ownership (or lesser proprietary interest, such as charge) by way of security in the rolling stock of the insolvent debtor, it can, in principle, segregate this rolling stock from other assets of the debtor and obtain repayment of the loan from the proceeds of sale.<sup>313</sup> The liquidator or trustee in bankruptcy of the insolvent debtor will not be able to keep the holder of property rights on the sidelines while it pays the debts owed by the insolvent debtor to its general creditors.<sup>314</sup> This does not mean that the personal right is completely destroyed by the insolvency of the debtor. Rather, it is transformed into a right to prove for its monetary value along with other creditors of the insolvent debtor.<sup>315</sup> Since the value of the assets of the insolvent debtor is often considerably smaller than its liabilities, the holder of a personal right usually has only minuscule chances of obtaining discharge. This feature of property rights on its own makes it clear why a creditor may be eager to establish that it has a property rather than a personal right over some identifiable asset of the insolvent debtor.

Despite clear indication of the importance of distinction between property and personal rights, the Convention does not explicitly define security and other international interests as either personal or property interests. The representatives of the aviation industry who took part in the drafting of the Convention and the

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<sup>309</sup> Ibid 619-620.

<sup>310</sup> Ibid 28.

<sup>311</sup> McCormack (n 10) 69.

<sup>312</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 649.

<sup>313</sup> Ibid 615.

<sup>314</sup> This is often subject to privileged treatment accorded by domestic insolvency law to certain categories of (preferential) creditors, e.g. wages of the employees. English law reduced the categories of preferential creditors stipulated in Sch 6 of the Insolvency Act 1986 by abolishing Crown Preferences, such as debts due to Inland Revenue, Customs and Excise and social security contributions. See s 251, Enterprise Act 2002.

<sup>315</sup> McKendrick (n 2) 29.



Aircraft Protocol insisted that its final text should reflect vital principles of asset-based finance and leasing and ensure that the interest acquired by the holder of the international interest is of a proprietary nature.<sup>316</sup> Likewise, the Restricted Working Group (RWG) which operated under the auspices of the UNIDROIT and consisted of representatives of financial institutions, industries and practising lawyers concluded that international interest should denote a proprietary interest in the asset of the debtor.<sup>317</sup> The RWG stated that as a proprietary right, the international interest should afford its holder an opportunity to follow the asset into the hands of third parties and to obtain discharge of the debt prior to other creditors of the debtor.<sup>318</sup>

Although the Convention does not explicitly refer to international interests as proprietary interests, its provisions allow one to conclude that the holder of the international interest acquires a property rather than simply personal rights in the object of the debtor. For example, Article 30 of the Convention provides that in insolvency proceedings against the debtor an international interest remains effective if it was registered in conformity with the Convention prior to the commencement of such proceedings. ‘Effective’ for the purpose of the Convention is said to reflect the proprietary nature of the international interest.<sup>319</sup> This means that, as a general rule, registered international interests should rank ahead of the claims of unsecured creditors of the insolvent debtor.<sup>320</sup>

In practice this provision may lead to the following consequences. If the satellite manufacturer needs to generate substantial amounts of finance for the manufacture of a new satellite, it may decide to take a loan from several lenders. Lender A (with whom the satellite manufacturer has long standing business relations) may provide the borrower with a loan without taking security or resorting to other international interests available under the Convention. A month later, lender B (who may have knowledge of the existence of lender A) agrees to loan to the borrower the remaining part of the required finance in return for a transfer of ownership in the satellite by way of security for repayment of the debt. Following this agreement, lender B registers its security in the satellite as

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<sup>316</sup> J Wool, ‘The Case for a Commercial Orientation to the Proposed UNIDROIT Convention as Applied to Aircraft Equipment’ (1999) 4 Unif L Rev 289, 291.

<sup>317</sup> Davies (n 198) 159-160.

<sup>318</sup> Ibid 159-160.

<sup>319</sup> Goode, Commentary (n 38) 231.

<sup>320</sup> Panahy and Mittal (n 274) 311.

international interest in the International Registry established in accordance with the Convention.<sup>321</sup> A year later, when the manufacture of the satellite is only partly completed the borrower files for insolvency. The insolvency administrator of the satellite manufacturer notifies the parties that it has taken possession of the objects of the insolvent debtor, including the satellite, and intends to sell them in order to distribute the proceeds of sale among the creditors of the borrower on a *pari passu* basis. Article 30 will allow lender B who has validly registered its security prior to the commencement of the insolvency proceedings to take the satellite out of the insolvent debtor's estate for the purpose of obtaining discharge of the debt. As a registered secured creditor, lender B will rank ahead of all unregistered secured and unsecured creditors of the insolvent debtor, including lender A. This will be the case even if lender B had actual knowledge that lender A was the first to extend finance to the borrower.<sup>322</sup> As noted earlier, the effectiveness of an interest held by the creditor during insolvency proceedings against the debtor constitutes one of the incidents of the property right and can be explained by the fact that the former obtains a right which is good against the whole world in the property of the latter. The fact that the Convention provides that international interests should remain valid in insolvency clearly indicates that such an interest is necessarily of a proprietary rather than personal nature.

This also means that the interest of lender B will not only be effective during insolvency proceedings, but is also likely to survive insolvency of the debtor. Although no cases decided under the Convention were yet reported to support this point, one English case may prove to be useful in this regard. In this case<sup>323</sup> *Hugh Lind*, in return for a loan, mortgaged the possibility of becoming possessed in the future of a share of his mother's personal estate first to the Norwich Union Life Insurance Society and three years later to another lender – H. L. Arnold. In the same year he was adjudicated bankrupt and obtained his discharge. Neither Norwich Union nor Arnold tried to enforce their security at that time. Six years later, Mr Lind's mother died and he assigned his share in her estate to which he then actually became entitled to the plaintiffs. The plaintiffs argued that the securities of the first two lenders were of no value and that the plaintiffs were

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<sup>321</sup> For a more detailed discussion of the issues of registration under the Convention see Chapter III.

<sup>322</sup> Art 29(1)(a), the Convention.

<sup>323</sup> *In Re Lind, Industrial Finance Syndicate, Limited v Lind* [1915] 2 Ch 345.

entitled to the encumbered share of Mr Lind. The plaintiffs based their claim on the bankruptcy and discharge of the debtor, stating that after discharge the debtor was entitled to a ‘fresh start’ free from old contractual obligations.<sup>324</sup> The reasoning of Court of Appeal turned on the question whether assurances of Mr Lind to Norwich Union and Arnold rested in the contract or whether they amounted to real security in the potential share of Mr Lind and became enforceable once such property came into existence. It was held that because the assurances given to Norwich Union and Arnold were security interests and conferred on secured creditors a proprietary and not merely personal right in the share of Mr Lind, these security interests survived his bankruptcy and had to be ranked ahead of plaintiff’s interest. By analogy with this case, consider the position of lender B in our illustration who decided not to enforce its security at the start of the insolvency proceedings because the manufacture of the satellite was not yet completed. If the debtor emerges out of insolvency some two years later and in the hope of having a fresh start obtains a loan to proceed with the manufacture of the satellite from lender C in return for a registered security in this satellite, can lender B still enforce its security? Since the satellite was appropriated to the repayment of the loan and lender B’s interest was of proprietary nature, its security should be able to survive borrower’s insolvency and rank ahead of lender C’s security.

Article 29 of the Convention can serve as another indicator of the proprietary nature of international interests.<sup>325</sup> Article 29(1) provides that ‘a registered interest has priority over any other interest subsequently registered and over an unregistered interest’. This provision sets the order of priority first, between registered interests and secondly, between registered and unregistered interests.<sup>326</sup> As between registered interests, priority is accorded to the interest that was registered first.<sup>327</sup> As between registered and unregistered interest, registered

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<sup>324</sup> Ibid 357.

<sup>325</sup> Priority, along with effects in insolvency (discussed above) and ability to follow the asset and trace its proceeds into the hands of a third party are often said to be common incidents of property rights. These incidents are frequently considered to be integral to security simply because of its proprietary nature. Presumably, if one can find all three incidents in an interest (such as international interest under the Convention), its legal nature must necessarily be proprietary. Ali (n 32) 29-30.

<sup>326</sup> Goode, Commentary (n 38) 224.

<sup>327</sup> The provisions of the Convention on priority seem to be similar to those found in North American personal property security law. R Cuming, ‘Hot Issues’ in the Development of the

interest ranks ahead of unregistered interest even if unregistered interest was created before the registered one.<sup>328</sup>

The privileged treatment of international interests, including security can be explained by their proprietary nature: once the debtor who owns the asset (or holds a lesser property interest in the asset) transfers its interest in this property to secured creditor, the latter becomes the holder of such proprietary interest.<sup>329</sup> Since the secured creditor becomes the holder of property in the asset, it becomes entitled to take this asset away in priority to those creditors who only have personal or contractual rights against the debtor.<sup>330</sup> Similarly, holders of other international interests also have proprietary rights in the asset which can explain privileged treatment accorded to them over subsequently registered and unregistered interests. A conditional seller under a title retention agreement retains or reserves its ownership of the asset until the buyer pays the purchase price. The conditional seller never parts with its proprietary interest in the asset until the fulfilment of agreed conditions by the buyer. Should the buyer file for insolvency, it seems only right that the unpaid seller should be able to take its property back without the need to join the queue of unsecured creditors.<sup>331</sup> The priority of the lessor can be explained in the same way: the lessor is entitled to be treated in priority to other creditors of the lessee because it holds the ownership (or a lesser property right) in the asset and allows the lessee to use its property in return for payment.<sup>332</sup> Similar to the conditional seller, the lessor simply takes what belong to it and for this reason should not be kept in the queue of the creditors who only have personal claims against the insolvent debtor.<sup>333</sup>

The indisputable character of priority enjoyed by secured creditor over unsecured creditors or liquidator of insolvent debtor is evident from many cases decided under English law.<sup>334</sup> In one case, a company obtained a loan from the

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(Draft) Convention on International Interests in Mobile Equipment and the (Draft) Aircraft Protocol' (2000) 34 Int'l Law 1093, 1098.

<sup>328</sup> Ibid 1098.

<sup>329</sup> L Ponoroff and F Knippenberg, 'Having One's Property and Eating it Too: When the Article 9 Security Interest Becomes a Nuisance' (2006) 82 Notre Dame L Rev 373, 393-395.

<sup>330</sup> Ibid 393-395.

<sup>331</sup> McCormack (n 10) 69.

<sup>332</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 203-208.

<sup>333</sup> Ibid 203-208.

<sup>334</sup> Priority enjoyed by the secured creditor can be considered as a general rule, which is often subjected to restrictions imposed by law in various jurisdictions for a number of reasons (e.g. to protect vulnerable unsecured creditors). For instance, under English law, failure to register a

plaintiffs in exchange for security in ‘all the stock, plant, chattels, and effects which may from time to time be held by the company’.<sup>335</sup> Before the principal money became due or the interest had fallen into arrears, the borrower went into liquidation. The liquidators of the insolvent company took possession of all its property and were about to apply it for the benefit of its ordinary creditors. In the dispute between secured creditors (the plaintiffs) and liquidators of the insolvent company, the court gave priority to secured creditors even though the time for repayment of the debt has not yet arrived. It was held that once the company becomes insolvent, security becomes immediately enforceable and secured creditor should not be kept on the sidelines while unsecured creditors obtain their discharge out of the property encumbered by security. Priority which seemed to flow from the proprietary nature of the interest held by secured creditor was also evident in another case.<sup>336</sup> The facts of the case were as follows. The insolvent company owed money both to unsecured and secured creditors. One of unsecured creditors obtained judgment against the insolvent company. Instead of approaching the insolvent company for the repayment of the debt, an unsecured creditor served a garnishee order nisi on the debtor of the insolvent company. In accordance with the garnishee order nisi, the debtor was required to pay its debt to the unsecured creditor instead of its original creditor. The secured creditor argued that the debt belonged to the insolvent company and was for this reason encumbered by security. It was held that the garnishee order nisi did not transfer ownership in the debt from insolvent company to unsecured creditor. Accordingly, the debt remained encumbered by security and the secured creditor was able to obtain discharge out of this money prior to the unsecured creditor. The proprietary nature of security and privileged treatment which it affords to a secured creditor allowed it to extend its hands to such property of the insolvent

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registrable charge within 21 days of its creation will invalidate it in the case of the debtor’s liquidation which may have effect on the order of priority among the debtor’s other creditors. See McCormack (10) 7.3; In addition, preferential creditors are ranked ahead of floating charges. See s. 40 (stating that administrative receiver must pay to preferential creditors before making any payments arising under debentures secured by a floating charge); s 175 of the Insolvency Act 1986 (indicating that if the unencumbered assets of a company are not sufficient to meet the claims of preferential creditors, they are to be paid out of assets subject to the floating charge in priority to the chargee itself). See also *Re H&K Medway Ltd* [1997] 1 WLR 1422. This issue will be explored in more detail in Chapter IV.

<sup>335</sup> *Hodson v Tea Company* (1880) 14 Ch D 859. See also *Wallace v Universal Automatic Machines Company* [1894] 2 Ch 547; *In Re Crompton & Co Ltd* [1914] 1 Ch 954 for similar results.

<sup>336</sup> *Norton v Yates* [1906] 1 KB 112.

borrower which has not yet even reached its intended recipient! Finally, another case can demonstrate just how strong a privileged position of the secured creditor can be.<sup>337</sup> In this case a company obtained a loan on security from the secured creditor. The borrower duly paid all interest to the secured creditor. The principal sum has not yet become payable and the borrower was not in default or breach of contract between itself and the secured creditor. At this stage, another creditor of the borrower obtained a judgment against it, ordering the borrower to repay sums due to this creditor. In these circumstances, the secured creditor was able to successfully appoint a receiver which resulted in that the borrower was unable to deal with its property and pay to the judgment creditor. The court held that since the secured creditor was the holder of a proprietary interest in the property of the borrower, it could enforce the security on the ground that such security was in jeopardy. Although Buckley J felt that the outcome of the case was possibly unjust with respect to the judgment creditor, he stated that ‘the creditor never had any right as between himself and the debenture-holder [secured creditor] to enforce payment in priority to the debenture-holder’.<sup>338</sup>

Article 29(6) of the Convention is also indicative of the proprietary nature of international interests. According to this provision ‘any priority given by this Article to an interest in an object extends to proceeds’. The ability to follow the object or trace its proceeds in case of unauthorised disposition is often considered as another incident of property rights held in such object: as a general rule, the owner (or the holder of a lesser proprietary right) is entitled to take its property back from a third party.<sup>339</sup> Article 1(w) of the Convention, however, defines ‘proceeds’ in a restrictive manner. ‘Proceeds’ under the Convention are limited to monetary or non-monetary proceeds resulting from total or partial loss of the object (such as insurance payments) or total or partial confiscation, condemnation or requisition.<sup>340</sup> For instance, if a borrower sells a train wagon, which is encumbered by a security, to a third party and retains the proceeds of sale in its bank account, a secured creditor who has a registered international interest in the

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<sup>337</sup> *Campbell v London Pressed Hinge Company, Limited* [1905] 1 Ch D 576.

<sup>338</sup> *Ibid* 582, per Buckley J.

<sup>339</sup> This general rule may be subjected to exceptions allowing a third party to override the title of the initial owner. See, generally, Ali (32) 30; A Oakley, ‘Proprietary Claims and Their Priority in Insolvency’ [1995] CLJ 377, 378-81; J Beatson and N Andrews, ‘Common Law Tracing: Springboard or Swan Song?’ (1997) 113 LQR 21.

<sup>340</sup> Goode, *Commentary* (38) 163.

wagon will not be able to follow the collateral into the proceeds of sale under the Convention. If the secured creditor were able to do so, it would broaden the scope of the Convention beyond the categories of objects listed in Art 2(3).<sup>341</sup> In contrast, if the charged satellite is insured against loss and is later destroyed by collision with another satellite orbiting the Earth, the secured creditor's interest in the collateral will extend to the insurance proceeds.<sup>342</sup>

### 3.4 Proprietary nature of interests: distinction between security and international interests

As the above discussion illustrates while the Convention leaves the question of characterisation of security, retention of title and leases to the applicable domestic law, there is an underlying requirement that, in order to constitute an international interest under the Convention, the interest in question should be recognised by the domestic law as proprietary in nature. For this reason, a personal guarantee of the directors supporting the grant of a security interest in the satellite in the above example, which only provides a personal and not a real security to the secured creditor, is unlikely to constitute an international interest under the Convention. If a security or other international interest is created in accordance with Articles 2 and 7 and arises exclusively under the Convention, this interest will too have a proprietary rather than personal nature. This can be supported by the major features of international interests constituted under the Convention: such interests remain effective in insolvency, allow its holder to enjoy priority over subsequently registered or unregistered interests and, to a certain extent, to trace the proceeds associated with the object. Since the international interests are of proprietary nature, the Convention does not distinguish between security, title retention and lease at the stages of creation, registration and priorities of international interests.<sup>343</sup> At the same time, the origins of these proprietary

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<sup>341</sup> Another reason why 'proceeds' are narrowly defined by the Convention is to avoid it from covering issues which are already governed by the UN Convention on the Assignment of Receivables in International Trade 2001. See Goode, Commentary (38) 163.

<sup>342</sup> For another example of operation of Art 29(6) see Goode, Commentary (38) 230 (Illustration 25).

<sup>343</sup> This approach differs from the one adopted by some legal systems. For instance, under English law, while most security interests need to be registered, retention of title clauses as well as leases do not, generally, require registration. Furthermore, a valid retention of title clause has a super-priority status overriding even security interests. See s 860 Companies Act 2006, replacing s 395

interests are different. The secured creditor obtains its interest in the object because it is granted to it by the debtor as a security.<sup>344</sup> Although the secured creditor holds a property right in the object of the debtor and can, in principle, enforce it as a true owner in case of the debtor's default, its interest is not absolute and is defeasible by performance of the secured obligation.<sup>345</sup> Once the debtor repays secured loan and interest, the property interest held by the secured creditor in the object ceases to exist.<sup>346</sup> The ownership (or any other lesser interest which was transferred to the creditor as a security) in the collateral reverts back to the debtor.<sup>347</sup> The origins of interests held in the object by the conditional seller and lessor differ from the interest held by the secured creditor. Instead of relying on the grant of such interest from the debtor, the conditional seller and lessor already have a property interest in the object. The conditional seller and lessor simply retain their property interest until the purchase price is paid or for the duration of the lease.<sup>348</sup> While at the stages of creation, registration and priority the difference in the origins of international interests may be of little practical significance, it becomes relevant when the creditor needs to exercise its remedies.<sup>349</sup> For this reason, the remedial part of the Convention reflects the way in which a property interest in the object was initially originated in the secured creditor, conditional seller or lessor as the case may be.

While remedies of the secured creditor can be found in Articles 8 and 9, the conditional seller and lessor should use remedies contained in Article 10 of the Convention. Such deliberate grouping of the remedies of a secured creditor on the one hand and the remedies of a conditional seller and lessor on the other hand reflects the fact that a secured creditor, unlike a conditional seller and lessor is not an absolute owner of the object.<sup>350</sup> Article 10 is noticeably less detailed than Articles 8 and 9 because the conditional seller and lessor only need the remedies

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Companies Act 1985; See Beale, Bridge, Gullifer, Lomnicka (n 13) 23-24; In contrast, under Art 9 UCC, retention of title clauses as well as some leases require registration. See White and Summers (n 33) 741.

<sup>344</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 19.

<sup>345</sup> Ibid 17.

<sup>346</sup> Ibid 29.

<sup>347</sup> The debtor's right to get the object back by discharging the secured obligation is often referred to as the right to redeem and constitutes one of the incidents of security interest. See *Re George Inglefield Ltd* [1933] Ch 1, 27-28.

<sup>348</sup> Beale, Bridge, Gullifer, Lomnicka (n 13) 20.

<sup>349</sup> This approach of the Convention seems to reflect the position under Art 9 UCC. See Bridge, Macdonald, Simmonds, Walsh (n 108) 584-585.

<sup>350</sup> Goode, Commentary (n 38) 180.



of termination of the agreement and taking of possession or control of the object to which such agreement relates.<sup>351</sup> Once possession or control of the object is delivered back to the conditional seller or lessor, they are free to deal with it as owners: when the conditional seller or lessor receives back its aircraft, it may decide to lease it to another airline, sell it, or simply donate it to a local science museum. Since both the conditional seller and lessor are owners of the object they need not seek consent of the conditional buyer or lessee regarding the way in which they deal with their property.<sup>352</sup> If a conditional seller or lessor resells the object at a sum in excess of what a conditional buyer or lessee would have paid to them under their contracts, the conditional seller or lessor do not need to account for the profit to their former contracting parties. Nor do conditional seller and lessor have to apply the proceeds of resale of the object in a way that would be agreeable to the conditional buyer or lessee: conditional seller or lessor can invest the money into their businesses, put it into their bank accounts or deal with it in any other way.

A secured creditor is placed into a different position to that of a conditional seller or lessor. Similar to the conditional seller or lessor, the secured creditor can take possession or control,<sup>353</sup> sell or grant a lease over any object charged to it.<sup>354</sup> But, crucially, the secured creditor cannot dispose of the object as if it were its absolute owner. Article 8(5) provides that any sum collected by the secured creditor as a result of a sale or the grant of a lease or any other acceptable disposition of the object must be applied towards discharge of the amount of the secured obligation. Thus, a secured creditor cannot resell an aircraft engine which was appropriated to discharge of the loan and use the proceeds of sale for payment of the overdraft at the debtor's bank account held by it with the lender. Instead, such proceeds should only be applied towards repayment of the secured loan. If a secured creditor resells collateral at a profit and receives a sum which exceeds the amount of secured obligation, it cannot dispose of the surplus as it pleases.<sup>355</sup> In contrast to the conditional seller or lessor, the secured creditor should distribute the surplus among 'holders of subsequently ranking interests which have been

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<sup>351</sup> Ibid 187.

<sup>352</sup> Ibid 187.

<sup>353</sup> Art 8(1)(a), the Convention.

<sup>354</sup> Art 8(1)(b), the Convention.

<sup>355</sup> Goode, Commentary (n 38) 182.

registered or of which the chargee has been given notice, in order of priority, and pay any remaining balance to the chargor.’<sup>356</sup> This provision demonstrates that a secured creditor cannot amount to a true owner of the collateral and for this reason cannot keep to itself more than is necessary for discharge of the secured obligation: after all holders of subsequently ranking interests have obtained their discharge, the remaining sum should revert to the true owner of the collateral, namely the debtor.

What would be the position of the secured creditor and the debtor if the resale of collateral did not generate a sufficient amount of money to repay the debt?<sup>357</sup> Consider a lender who has provided finance to an airline for the purpose of the acquisition of a new aircraft. When the airline defaults in one of its monthly payments some two years after the loan was granted, the secured lender may decide to take possession and resell the collateral. The cost of the aircraft which has been in use for two years may, however, be considerably lower than the cost of the new one. For this reason, the proceeds of resale may be insufficient for the discharge of the airline’s debt. Articles 8 and 9 of the Convention do not seem to provide an answer to this question. In this regard one leading English case in which Romer LJ attempted to explain major differences between a true sale and a security may provide some assistance.<sup>358</sup> He stated that:

‘In a transaction of sale the vendor is not entitled to get back the subject-matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge the mortgagor is entitled to, until he has been foreclosed, to get back the subject-matter of the mortgage or charge by returning to the mortgagee the money that has passed between them. The second essential difference is that if the mortgagee realises the subject-matter of the mortgage for a sum more than sufficient to repay him, with interest and the cost, the money that has passed between him and the mortgagor he has to account to the mortgagor for the surplus. If the purchaser sells the subject-matter of the purchase, and realises a profit, of course he has not got to account to the vendor for the profit. Thirdly, if the mortgagee realises the mortgage property for a sum that is insufficient to repay him the money that he has paid to the mortgagor,

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<sup>356</sup> Article 8(6), the Convention. The position is similar under English law. See s. 105 Law of Property Act 1925.

<sup>357</sup> For a more detailed examination of this issue see Chapter V.

<sup>358</sup> *Re George Inglefield Ltd* [1933] Ch 1.

together with interests and costs, then the mortgagee is entitled to recover from the mortgagor the balance of the money<sup>359</sup>...If the purchaser were to resell the purchased property at a price which was insufficient to recoup him the money that he has paid to the vendor, of course he would not be entitled to recover the balance from the vendor.<sup>360</sup>

While the Convention expressly allows the debtor to redeem the collateral<sup>361</sup> and indicates that any surplus should eventually revert back to the debtor,<sup>362</sup> it does not say what a secured creditor should do if the proceeds of resale are insufficient to repay the loan together with the interest. It seems that, similar to the position under English law, the secured creditor should be entitled to recover from the debtor the remaining sums. This should be the case because until the secured loan is fully repaid to secured creditor, the debt is still in existence and the debtor should be accountable for its repayment.

Finally, Article 9(4) of the Convention provides that ‘At any time after default ... and before the sale of the charged object...the chargor...may discharge the security interest by paying in full the amount secured...’. This provision also sheds some light on the nature of the interest held by a secured creditor in the collateral. Even when the debtor transfers ownership in the object to the secured creditor, the transfer is only made by way of security and not by way of an absolute transfer. Since the secured creditor only holds its interest in the collateral as a means of securing repayment of the loan, the debtor must have a right to redeem or return the property back by performing the secured obligation. The debtor continues to have the right of discharge of collateral even after default and up until such time when secured creditor sells the collateral for the purpose of obtaining the repayment of the loan.

What would be the position of contracting parties if prior to discharge of the debt and before the sale of the object, the secured creditor disposes of it in a way which can make it difficult for the debtor to exercise its right of discharge? Following several missed payments by the debtor, the secured creditor may decide to take possession and grant a lease over the object to a lessee. Can the debtor still tender the money in order to discharge the object? This may seem to be difficult

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<sup>359</sup> Emphasis added by the author.

<sup>360</sup> Re George Inglefield Ltd [1933] Ch 1, 26-27.

<sup>361</sup> Art 9(4), the Convention.

<sup>362</sup> Art 8(6), the Convention.

once the asset has already been delivered and is being used by the lessee. However, Article 9(4) of the Convention states that the right of discharge of the debtor continues to exist even if the secured creditor grants a lease over the object to a lessee and should be exercised subject to such lease. In such circumstances, it seems that the debtor can still perform the secured obligation and step into the shoes of the secured creditor as a lessor with respect to the new lessee. Once the lease is discontinued the property interest held by the debtor/lessor can be fully restored to it in its unencumbered state.<sup>363</sup>

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<sup>363</sup> The Convention does not expressly indicate whether contracting parties can include in their security agreement a clause which would confer an additional benefit on the secured creditor. For instance it is not clear whether contracting parties can agree that while the security agreement is still in force, the secured creditor may have an option to purchase the collateral thereby eliminating the debtor's right of discharge. Some legal systems express a very strong support in favour of the debtor's right to discharge or redeem the charged property and disapprove of anything which can have an effect of clogging this right. English law, for instance, is not likely to easily uphold a clause in a mortgage agreement allowing a mortgagee to purchase the collateral while the security agreement is still running since if such an option is exercised by the mortgagee, the mortgagor's right of redemption will be effectively ousted. At the same time, it was argued elsewhere that in cases of commercial transactions the rules preventing clogs on redemption should not be as strict as they used to be. For the general position on clogs on redemption under English law, see *Samuel v Jarrah Timber and Wool Paving Corporation, Ltd* [1904] AC 323; *Santley v Wilde* [1899] 2 Ch 474; *G and C Kreglinger v New Patagonia Meat and Cold Storage Company, Ltd* [1914] AC 25.

## Chapter II: Constitution of Security and other International Interests under the Convention and the Protocols

### 1. General

In order to protect its proprietary interest in the equipment, the creditor must, first of all, ensure that a valid international interest is created and it is with this issue that this Chapter is concerned. The constitution of an international interest raises a number of questions. First, although the Convention provides that an agreement for the international interest must be in written form, it is not clear whether this agreement must contain any particular terms in order to be valid. Secondly, the chargor, conditional seller or lessor must have power to dispose of the object, yet this term is not defined by the Convention. Thirdly, what degree of precision is required for the purpose of identifying the object in the agreement of the international interest? Finally, is it possible to create a floating security in aircraft and railway objects under the Convention? Each of these questions will be addressed in turn.

#### 1.1 The effect of the constitution of the international interest

The first step that a creditor<sup>1</sup> under a security agreement or other applicable agreement has to make in order to protect its interest in an asset held by a debtor is to ensure that a valid international interest in this object is created. To achieve this end, parties to a transaction must follow the formal requirements prescribed by Article 7 of the Convention. An interest is constituted as an international interest where the agreement creating a security interest or providing for an interest<sup>2</sup> of a conditional seller or lessor a) is in writing; b) relates to an object of

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<sup>1</sup> Art 1(i) of the Convention defines 'creditor' as a chargee under a security agreement, a conditional seller under a title reservation agreement or a lessor under a leasing agreement.

<sup>2</sup> Once the formal requirements are met, the agreement between the parties '*creating*' or '*providing for the interest*' gives rise to a valid international interest. The agreement between the parties is said to '*create*' the interest in the case of a security agreement and '*provide for the interest*' in the cases of retention of title and lease agreements. Such wording of Art 7 reflects the way in which the interests of a secured creditor, conditional seller and lessor are normally obtained. While the interest of a secured creditor in the asset is usually created by its agreement with a debtor, the interests of a conditional seller and lessor do not depend on their agreements with buyer and lessee, but precede these agreements. For this reason, the international interest will arise not at the moment when the interests of the conditional seller and lessor in the asset are acquired, but when

which the chargor, conditional seller or lessor has power to dispose; c) enables the object to be identified in conformity with the Protocol and d) in the case of a security agreement, enables the secured obligations to be determined, but without the need to state a sum or maximum sum secured.<sup>3</sup> Article VII of the Aircraft Protocol<sup>4</sup> and Article V of the Luxembourg Protocol<sup>5</sup> provide the necessary identification requirements for the purposes of Article 7(c) of the Convention.<sup>6</sup>

The Convention is silent as to the effect of the creation of the international interest in that it does not state whether, once the international interest is constituted, it becomes valid only between the parties to the agreement or whether it becomes effective against third parties as well. One view is that, once the international interest is constituted it becomes effective only between the parties to the agreement, but not necessarily against third parties.<sup>7</sup> To make its interest enforceable against third parties, the creditor has to perfect or register it in the International Registry.<sup>8</sup> However, this position may be difficult to support because security interests as well as other international interests under the Convention are

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they enter into the agreements with conditional buyer and lessee in order to retain their interest until certain conditions are met or for the duration of the lease. See R Goode, 'The International Interest as an Autonomous Property Interest' (2004) 1 ERPL 18, 22.

<sup>3</sup> Art 7, the Convention.

<sup>4</sup> The Convention and Aircraft Protocol were concluded and opened for signature on 16 November 2001 at the Diplomatic Conference held at Cape Town under the auspices of the UNIDROIT and ICAO. All the provisions of the Convention and Aircraft Protocol relating to aircraft objects came into force as of 1 March 2006 pursuant to Articles 49(1) of the Convention and XXVIII of the Protocol. While a country may become a party to the Convention without acceding to the Protocol, the reverse cannot be achieved. In order to become a party to the Protocol, a country must become a party to the Convention as well. See R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*, Revised edn (Rome, UNIDROIT 2008) 106. (Hereafter referred to as *Commentary*); L Clark and J Wool, 'Entry into Force of Transactional Private Law Treaties Affecting Aviation: Case Study – Proposed UNIDROIT/ICAO Convention as Applied to Aircraft Equipment' (2001) 66 *J Air L Comm* 1403.

<sup>5</sup> The Luxembourg Protocol on matters specific to railway rolling stock was concluded and opened for signature on 23 February 2007 at the Diplomatic Conference in Luxembourg. The Conference was hosted by the Government of Luxembourg and held under the auspices of the UNIDROIT and the Intergovernmental Organisation for International Carriage by Rail (OTIF). R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock* (Rome, UNIDROIT 2008) 2; H Kronke, 'The Luxembourg Protocol to the Cape Town Convention: A Pillar for the Bridge to the Future of Rail Transportation' (2007) *Unif L Rev* 420.

<sup>6</sup> The drafting work on the Protocol on matters specific to space objects is still in progress. The definition of space assets for the purposes of Art 7 of the Convention can be found in (Draft) Art 1.2(f) of the Space Protocol. For a general overview of the Space Protocol see O Ribbelink, 'The Protocol Specific to Space Assets' (2004) 1 ERPL 37-45.

<sup>7</sup> Goode (n 2) 22. For the similar view in the context of English law see L Gullifer (ed), *Goode on Legal Problems of Credit and Security*, 4<sup>th</sup> edn (London, Sweet & Maxwell 2008) 2-16.

<sup>8</sup> Gullifer (n 7) 2-16.

of the proprietary rather than the personal nature.<sup>9</sup> It follows that, once constituted, such interests should be effective both against the debtor and against third parties.<sup>10</sup> The only proprietary right in the object which can be obtained by the secured creditor can be given to it by the debtor itself as it is the debtor who has the power to dispose of its interest by way of security. The only moment when the proprietary right in the object can be transferred to the creditor as a security seems to be the moment of the creation of the international interest, i.e. when the requirements of Article 7 are met. The mere fact of registration cannot confer on the creditor a proprietary right in the object which the creditor can then enforce against third parties.<sup>11</sup> At the time of registration of the international interest, the creditor must necessarily already be the holder of the proprietary right in the object of the debtor. This may also be supported by the fact that the main purposes of registration are to give notice to third parties of the existence of the creditor's interest and to secure the creditor's priority among third parties,<sup>12</sup> not to convert an interest which was previously effective only between the creditor and the debtor into an interest which is enforceable against third parties. Since the provisions of the Convention seem to support the view that the holder of the international interest obtains a proprietary or in rem right and not simply a contractual or in personam right against the debtor in the asset,<sup>13</sup> it is submitted that once the formal requirements of Article 7 are met, the creditor becomes the holder of a newly constituted international interest which is valid against the debtor as well as potential third parties. If the effect of the constitution of the international interest were simply to affect the relationship between the creditor and the debtor, the international interest would not be any different from a mere contractual right of the creditor against the debtor in relation to the asset in

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<sup>9</sup> T Josipovic, 'The Rail Protocol and Croatian Secured Transactions Law' (2007) *Unif L Rev* 489, 493.

<sup>10</sup> P Ali, *The Law of Secured Finance: An International Survey Of Security Interests Over Personal Property* (Oxford, OUP 2002) 52.

<sup>11</sup> D Furnish, 'The Creation and Notice of Security Interests in Movable Property' (2003) 36 *UCC L J* 1 Art 3.

<sup>12</sup> P Honnebier, 'New Protocols and the Financing of Aircraft Engines' (2006) 21 *Air Space Law* 15, 16.

<sup>13</sup> For example, Art 29 of the Convention highlights the privileged position of the holder of the international interest by stating that a registered international interest is treated in priority to subsequently registered and unregistered interests. Art 30 of the Convention also seems to support the view that the nature of the international interest is of a proprietary rather than contractual character. This provision of the Convention states that the international interest remains effective in the case of the debtor's insolvency which allows the holder of such interest to take the asset out of the insolvent debtor's estate in order to discharge its liability.

question.<sup>14</sup> In fact, the position of such a creditor would not be much different from the position of an unsecured creditor of the debtor.<sup>15</sup>

This means that once the international interest comes into existence, the creditor is entitled to a privileged treatment and can, in principle, take the asset to the exclusion of third parties in order to discharge the liability of the defaulting debtor.<sup>16</sup> If the secured creditor (of a solvent debtor) intending to take possession of the collateral learned that its only competitors for the object were the unsecured creditors of the debtor, the secured creditor would be, generally, entitled to take the collateral in priority to these unsecured creditors as the holder of the right in rem in the asset of the debtor.<sup>17</sup> In practice, the secured creditor will often have to compete with other holders of international interests who, similar to the secured creditor, will have rights in rem in the same object held by the debtor. As holders of proprietary rights in the object, the secured creditor and other holders of international interests will, generally, be entitled to cut off the claims of the unsecured creditors of the debtor, but will have to find a way of ordering their own claims in order to accommodate the needs of all holders of international interests. This may result in the interest of the secured creditor being postponed by interests of other holders of international interests. But this does not necessarily mean that the interest which was created in accordance with Article 7 was only effective between the secured creditor and the debtor and not enforceable against

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<sup>14</sup> Ali (n 10) 52.

<sup>15</sup> Ibid 52.

<sup>16</sup> The position appears to be similar under Article 9 UCC which refers to the process of creation of the security interest as attachment. S 9-203(b) of Article 9 provides that once the formal requirements for creation of the security interest are met, the security interest becomes 'enforceable against the debtor and third parties with respect to the collateral.' This means that, generally, the secured creditor can take the collateral to the exclusion of third parties. At the same time, an attached but unperfected security interest can be defeated by a perfected security interest of a third party. To protect the security interest from the attacks of third parties, its holder should perfect it by filing or other means. See Uniform Commercial Code: Official Text and Comments, 2009-2010 edn (Thomson West 2009) 882-883. For the examination of the 2003 version of s 9-203(b) see J White and R Summers, Uniform Commercial Code, 5<sup>th</sup> edn (West Group 2000) 748.

<sup>17</sup> Gullifer (n 7) 2-02; The position under English law may be different in the case of the debtor's insolvency. The order of priority between the creditors will, to some extent, depend on whether the security interest is perfected by registration. This may mean that a validly created registrable, but unregistered charge may not be valid against third parties. See ss 860-874 Companies Act 2006. Art 29(1) of the Convention prescribes that as between two or more competing interests, a registered interest has priority over any other interest subsequently registered and over an unregistered interest. But registration is only relevant to determine the order of priority between the holders of the interests governed by the Convention which do not include the interests of unsecured creditors of the debtor. Since the interests of unsecured creditors are not proprietary in nature they should be, generally, postponed to the proprietary international interests. Domestic laws often subject this rule to various exceptions to protect the interests of certain groups of unsecured creditors. These issues are explored in more detail in Chapter IV.



third parties. It is suggested that it only means that as between two or more holders of rights in rem one of such holders will have to give way to the others. Much like when two persons are about to come into a room, they will not be able to cross the doorway at the same time, so that while, both are entitled to enter the room, one will have to postpone its right to the right of the other.

To allow the secured creditor to determine its priority position in relation to other creditors before the loan to the debtor is extended, the Convention provides for an additional mechanism which enables creditors to learn about other interests in the object, give notice of the existence of their own interest to other potential creditors and establish their point of priority in relation to other creditors of the debtor.<sup>18</sup> To achieve these ends, the creditor can register its interest in the International Registry.<sup>19</sup> One of the effects of such registration will be the ability of the secured creditor to defeat the claims of some other holders of international interests.<sup>20</sup> But this does not mean that it is only on registration or ‘perfection’ as it is often referred to in some legal systems, that the security interest will become effective against third parties.<sup>21</sup> By registering the international interest the creditor can ‘perfect’ the existing proprietary interest in the asset, not to create one.

## 1.2 The autonomous nature of the international interest

The formal requirements of Article 7 are essential for the constitution of a valid international interest and may not be added to by national law.<sup>22</sup> It follows that once these requirements are met a valid international interest comes into existence even if such requirements would not be sufficient to create an equivalent or

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<sup>18</sup> Goode, Commentary (n 4) 49.

<sup>19</sup> Similar to English law, registration is not a formality requirement under the Convention. However, this position is not uniform and some legal systems require an interest to be registered in order to be validly created. For example, Latin American Civil Codes require a security agreement to be registered in order to be valid. See J Wilson, ‘Movable Equipment Financing in Latin America: Application of the OAS Model Law, the Cape Town Convention and the Luxembourg Rail Protocol’ (2007) *Unif L Rev* 473, 483; For the position under the Convention see Goode, Commentary (n 4) 37; For the position under English law see Gullifer (n 7) 2-22.

<sup>20</sup> Goode, Commentary (n 4) 49.

<sup>21</sup> Registration is considered as one of the modes of perfection under Article 9 UCC. See White and Summers (n 16) 757.

<sup>22</sup> R Goode, ‘International Interests in Mobile Equipment: A Transnational Juridical Concept’ (2003) 15 *Bond L Rev* 9, 12; B Honnabier and J Milo, ‘The Convention of Cape Town: The Creation of International Interests in Mobile Equipment’ (2004) 1 *ERPL* 3, 7; M Stanford, ‘The New Regimen: Its History and Future after South Africa’ (2004) 1 *ERPL* 9.

similar interest under the otherwise applicable domestic law.<sup>23</sup> Conversely, any non-compliance with these formalities means that no international interest can be created and its purported registration will not be effective.<sup>24</sup> Another consequence of the autonomous nature of the international interest from the applicable domestic law is that compliance with Article 7 may result in the creation of an interest which has no equivalent in the domestic law of some jurisdictions.<sup>25</sup>

For example, under Belgian law, aircrafts are considered to be movable property and for that reason can only be pledged and not mortgaged.<sup>26</sup> One of the requirements of the validity of a pledge in this legal system is the delivery of possession of the collateral to the creditor.<sup>27</sup> Since dispossession of the debtor-airline would make it impossible for it to operate the aircraft and generate income for the purpose of repayment of the loan, the classical pledge is not normally used as it was intended by the legislator.<sup>28</sup> Instead, the industry developed a different financial structure to accommodate the needs of the parties concerned. Under this financial arrangement, the parties create a third company which acts as a purchaser or a lessor of the aircraft.<sup>29</sup> Once this third company obtains ownership of the aircraft it pledges it to the lender.<sup>30</sup> The lender, in turn, delivers the aircraft to the debtor-airline which holds the asset on behalf of the lender-pledgee.<sup>31</sup> The effect of this cumbersome structure is that, on the one hand, the pledgor delivers the possession of the collateral to the pledgee as required by the legislator, while, on the other hand, the debtor is able to operate the aircraft. Since delivery of the object is not required by Article 7 of the Convention, creation of the international interest would rid the parties in the above illustration of the necessity to construct this tri-partite structure. Instead, by following the requirements of Article 7 they

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<sup>23</sup> C Mooney, 'The Cape Town Convention: A New Era for Aircraft Financing' (2003) 18 *Air Space Law* 4.

<sup>24</sup> J Wool, 'The Next Generation of International Aviation Finance Law: An Overview of the Proposed UNIDROIT Convention on International Interests in Mobile Equipment as Applied to Aircraft Equipment' (1999) 20 *U Pa J Int'l Econ L* 499, 517.

<sup>25</sup> Goode, *Commentary* (n 4) 175.

<sup>26</sup> G Mauri and B Itterbeek, 'The Cape Town Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific to Aircraft Equipment: a Belgian Perspective' (2004) 9 *Unif L Rev* 547, 549.

<sup>27</sup> *Ibid* 549.

<sup>28</sup> V Sagaert, 'The UNIDROIT Convention on International Interests in Mobile Equipment: A Belgian Perspective' (2004) 1 *ERPL* 75, 77.

<sup>29</sup> *Ibid* 77.

<sup>30</sup> *Ibid* 77.

<sup>31</sup> *Ibid* 77.

should be able to create a non-possessory security interest over the aircraft without the involvement of a third company.

Some legal systems restrict the range of those parties who can be a creditor or a debtor under a security agreement. The law of secured transactions of Venezuela provides an example of such a restriction by narrowing the definition of debtors to those persons who have full ownership rights in the collateral.<sup>32</sup> In contrast, Article 7(b) of the Convention states that the security agreement must relate to the object of which chargor has power to dispose. This means that the chargor under the Convention does not have to be the owner of the collateral: mere power to dispose of the object should suffice for the creation of a valid international interest.<sup>33</sup> So, a debtor who only owns a fractional interest in an aircraft which may amount to as little as 10% of the ownership of the whole object, may still use its interest as a collateral under the Convention.<sup>34</sup> Another example may be found in Polish law of security interests. Recognising the limitations of the possessory pledge over movables, Polish law has introduced the concept of the non-possessory pledge.<sup>35</sup> However, the class of creditors who can take the non-possessory pledge allowing the debtor to retain the possession of the collateral is limited strictly to state-owned and other Polish banks.<sup>36</sup> In contrast, the Convention does not have similar restrictions which may enable a much broader category of businesses to act as creditors and debtors.<sup>37</sup>

Finally, since the formal requirements of Article 7 are for the most part simple,<sup>38</sup> the interest created under national law may at the same time constitute

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<sup>32</sup> H Gutierrez-Machado, 'The Personal Property Secured Financing System of Venezuela: A Comparative Study and the Case for Harmonisation' (1998) 30 U Miami Inter-American L Rev 343, 352. For a similar position in other jurisdictions see B Kozolchyk, 'What to do About the Mexico's Antiquated Secured Financing Law?' (1995) 12 Ariz J Int'l Comp L 523.

<sup>33</sup> R Cuming, 'Hot Issues' in the Development of the (Draft) Convention on International Interests in Mobile Equipment and the (Draft) Aircraft Equipment Protocol' (2000) 34 Int'l L 1093, 1097.

<sup>34</sup> See generally on fractional ownership programmes E Gleimer, 'When Less Can Be More: Fractional Ownership of Aircraft – The Wings of the Future' (1999) 64 J Air L Com 979.

<sup>35</sup> L Choroszuca, 'Secured Transactions in Poland: Practicable Rules, Unworkable Solutions and Pending Reforms' (1994) 17 Hastings Int'l Comp L Rev 389, 406-408.

<sup>36</sup> Ibid 406-408.

<sup>37</sup> Goode (n 5) 32.

<sup>38</sup> In contrast, some legal systems prescribe a more extensive list of formal requirements which must be met in order to create a valid security interest. Some jurisdictions require that a deed should be issued by a notary in order to create a security interest in an aircraft. See P Honnebier, 'The Dutch Real Rights of Airlines Can be the Basis of International Interests Under the Convention of Cape Town, Just Like Their Equivalent American Security Interests' (2004) 1 ERPL 46, 49; Other legal systems require a security agreement to be registered in order to be valid. See Wilson (n 19) 479. Similarly, a mortgage over an aircraft must be registered in order to be validly created under German law. See P Erbacher and K Gunther, 'Aspects of Aircraft Leasing

the international interest under the Convention so that the two interests will come into existence simultaneously.<sup>39</sup> In this case, the holder of such interests will still be entitled to the protection available under the applicable domestic law with respect to the national interest, but will lose its priority under the Convention, unless it registers its international interest in accordance with its registration regime.<sup>40</sup> At the same time, the parties to a transaction will not be able to assert rights which are available to them by virtue of national interests if such rights contradict the Convention.<sup>41</sup>

Although the international interest is the creation of the Convention and does not depend on domestic law, some issues in relation to its constitution are outside of the scope of the Convention and must be governed by the applicable domestic law.<sup>42</sup> These issues include the general capacity of the parties to contract, the effect of the vitiating factors on the validity of the contract and, in part, the question of whether the chargor, conditional seller and lessor have power to dispose of the object.<sup>43</sup>

### 1.3 Functions of the formalities

Formalities are sometimes described as legal requirements which make people do things in a particular way, usually the way which puts them to some extra trouble.<sup>44</sup> They are also referred to as external to the substance of the transaction: a set of mandatory rules designed by the legislator and supported by various sanctions in case the parties to a transaction decide not to follow them.<sup>45</sup> Formalities may have the disadvantage of increasing the cost of a transaction: it may be cheaper to conclude a contract over the phone rather than exchange

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in Germany' (1992) Int'l Comp Com L Rev 52, 54. For the description of the formalities for the creation of reservation of title agreements in various jurisdictions see G Monti, 'The Future of Reservation of Title Clauses in the European Community' (1997) ICLQ 866.

<sup>39</sup> Goode, Commentary (n 4) 175.

<sup>40</sup> J Atwood, 'A New International Regime for Railway Rolling Stock Asset-Based Financing' (2008) 40 UCC L J 3.

<sup>41</sup> Goode, Commentary (n 4) 175.

<sup>42</sup> Ibid 176.

<sup>43</sup> Ibid 176.

<sup>44</sup> P Birks, 'Before We Begin: Five Keys to Land Law' in S Bright and J Dewar (eds), *Land Law: Themes and Perspectives* (Oxford, OUP 1998) 457, 482.

<sup>45</sup> P Critchley, 'Taking Formalities Seriously' in Bright and Dewar (n 44) 507, 508.

written and signed contracts between the parties.<sup>46</sup> Considering these disadvantages of the formalities, would it not be better to rid the parties to a transaction of the obstacles such rules create and to allow them to arrange their business in their own informal way?<sup>47</sup> Surely, a debtor and a creditor who have a longstanding business relationship can agree between themselves that the creditor will grant the debtor a loan for the acquisition of an aircraft engine and that this object will be used as a security for the repayment of the loan? But it needs to be borne in mind that human memory fades with time and parties may later disagree as to the terms of the security agreement. When granting the security in the aircraft engine, the debtor may not have thought that the creditor will in fact enforce it. The distant probability of default and possible loss of the valuable asset may not have been fully appreciated by the debtor at the time of the informal conclusion of the security agreement. The creditor, too, may have its own concerns. Since the debtor retains possession of the aircraft engine, how is the creditor to ensure that the debtor will not dispose of the asset free of the creditor's interest? As one commentator vividly put it, 'a neighbour's right to pass over a field does not reveal itself in a pink line...'.<sup>48</sup> So too, the grant of a security in the aircraft engine by the debtor to the creditor is not visible to the eye of a third party. Formalities of Article 7 of the Convention may offer the parties to an agreement for the international interest the way of settling these and other potential concerns. The main functions of the formalities may help to illustrate the point.

#### a) Evidentiary function

The primary and most obvious function of formal requirements is to provide evidence of the existence and the precise terms of the agreement between the parties.<sup>49</sup> As time passes, the parties' may forget the details of their agreement and it may be reassuring to have an unbiased written document from which the

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<sup>46</sup> A Clarke and P Kohler, *Property Law: Commentary and Materials* (Cambridge, Cambridge University Press 2005) 461; C di Luigi, 'Divergences of Security and Property Law in the European Union: the Need for Action' (2008) JBL 526, 536.

<sup>47</sup> See J Baron, 'Gifts, Bargains, and Form' (1988-89) 64 Indiana LJ 155, in which various disadvantages of formalities are highlighted.

<sup>48</sup> Birks (n 44) 483.

<sup>49</sup> C Nelson and J Starck, 'Formalities and Formalism: A Critical Look at the Execution of Wills' (1978-79) 6 Pepp L Rev 331, 351.

original intentions of the parties can be safely discerned.<sup>50</sup> Before the agreement for the creation of an international interest is crystallised into writing, the parties will have to clarify its terms which may help to reveal new issues in need of negotiation.<sup>51</sup> The agreement reduced to writing may prove to be useful not only for the parties themselves, but for their successors in title (for instance, in case of the assignment of rights by one of the parties to a third party) as well as to a judge should the dispute between the parties be considered by a court.<sup>52</sup> The evidentiary function is usually accomplished by the formality of writing or notarial certification.<sup>53</sup> The requirement of signature of one or both of the parties which often accompanies the requirement of writing serves the function of authentication of the parties and can give the document the sense of completeness.<sup>54</sup>

#### b) Cautionary function

The requirement of writing as well as of obtaining a notarial certification as a prerequisite of a validity of the agreement can also warn parties against ill considered decisions and ensure that they understand that by complying with such formalities they enter into legally binding relationship.<sup>55</sup> A railway operator planning to increase its fleet of trains by acquiring new wagons with a loan secured by its existing trains, may not seriously consider the possibility of losing its assets in the event of default. Although the debtor may know that such possibility exists, its realisation may seem so unlikely and remote when the debtor is in the prime of its financial strength, that due consideration to such a possibility may not have been given by it at the moment of the grant of the security to the creditor.<sup>56</sup> Putting an agreement into writing conveys a certain degree of solemnity and ensures that the debtor will stop and think about the consequences

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<sup>50</sup> Birks (n 44) 483.

<sup>51</sup> Critchley (n 45) 515.

<sup>52</sup> Ibid 517.

<sup>53</sup> L Fuller, 'Consideration and Form' (1941) 41 Columbia L Rev 799, 800.

<sup>54</sup> Nelson and Starck (n 49) 349; Ss 1-3 of the Law of Property (Miscellaneous) Act 1989 can serve as another example of this function under English law.

<sup>55</sup> J Perillo, 'The Statute of Frauds in the Light of the Functions and Disfunctions of Form' (1974-75) 43 Fordham L Rev 39, 53.

<sup>56</sup> Just as delivery of an object makes vivid to the donor the seriousness of the act of giving the object away as a gift, a written grant of security may help the debtor to appreciate the seriousness of its acts with more clarity. P Mechem, 'The Requirement of Delivery in Gifts of Chattels and of Choses in Action Evidenced by Commercial Instruments' (1926) 21 Ill L Rev 341, 354.

of entering into the binding agreement for the creation of the international interest.<sup>57</sup>

### c) Channelling function

Formality requirements are also said to serve as ‘channels for the legally effective expressions of intention’.<sup>58</sup> When the parties to a transaction know which formal requirements will ensure the validity of their agreement, they will comply with these requirements in order to achieve this objective.<sup>59</sup> This message of the parties to the agreement creating an international interest can later be read and interpreted by the parties’ successors in title, the courts and third parties.<sup>60</sup> In contrast, if the parties do not comply with the prescribed formalities, one conclusion which may be drawn from their actions is that they did not intend their relationship to have a legal effect.<sup>61</sup>

## 2. The formal requirements of Article 7

What steps should a creditor take in order to create a valid international interest under the Convention? Article 7 prescribes that an agreement constituting the international interest must be put into a written form. The agreement must relate to the object of which the chargor, conditional seller and lessor has power to dispose and should allow the object to be identified in conformity with the relevant Protocols. Finally, in the case of a security agreement, it must enable the secured obligations to be determined, but without the need to state a sum or a maximum sum secured.

### 2.1 *‘Writing’*

#### a) The written form and some of its benefits

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<sup>57</sup> Nelson and Starck (n 49) 348-349 in which the ritual functions of formalities are discussed.

<sup>58</sup> Fuller (n 53) 801. For a similar view in the context of wills see J Langbein, ‘Substantial Compliance with The Wills Act’ (1975) 88 Harv L Rev 489, 493-494.

<sup>59</sup> Fuller (n 53) 801.

<sup>60</sup> Ibid 801-803.

<sup>61</sup> Clarke and Kohler (n 46) 457.

An agreement for the international interest must be put into a written form. So, an oral agreement for a security interest concluded at a meeting and witnessed by third parties, a lease agreed between the parties over a phone or an oral reservation of title agreement will not create a valid international interest.<sup>62</sup> It seems unlikely that the parties to a transaction involving highly expensive mobile equipment of the kind governed by the Convention will rely exclusively on oral communications to conclude what will usually be a meticulously detailed contract. Perhaps, the requirement of writing is nothing but a reflection of existing practices followed by parties ordinarily involved in such transactions. The written form has its benefits: once the agreement for the international interest is put into writing, the parties will have clear evidence of the terms to which they agreed. A written agreement may prove to be particularly useful where, for instance, a lessor agrees to give a right to possession of 10 train wagons to a lessee in return for rental payments for a 15 year period. This long-term lease is likely to include many detailed provisions in relation to such issues as the amount of rental and interest payments which may vary on a yearly basis, the periods when the parties agree to renegotiate the total amount payable under the lease, the definition of events which will constitute default by each party, enabling the other party to resort to the available remedies, the manner of disposal of the wagons by the lessee at the end of the lease and other related issues. With time, the written agreement may prove to be an invaluable reference point to which they can return in case of doubt. Finally, in the case of dispute, a written, as opposed to an oral agreement for the international interest will provide a judge or an arbitrator with tangible and solid evidence of the parties' intentions.

b) A single document and multiplicity of documents

The requirement of writing does not reveal whether the international interest agreement must be contained in a single integral document or whether a multiplicity of documents can give rise to a valid international interest. It seems

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<sup>62</sup> The insistence on written form is not uniform and some legal systems allow for an oral security interest to be created in certain circumstances. However, even if the legislator does not require a security agreement to be in writing, the parties concerned often prefer to put it in writing. See J Trapp, 'Luxembourg; Ownership; Security; Transfer-Legislative Comment' (2002) JIBL 48, 49; P Geortay, 'Transfer of Title by Way of Security Now Regulated in Luxembourg' (2003) JIBLR 76, 78.



clear that if an agreement which satisfies other requirements of Article 7 can be found in a written document entitled ‘agreement for the international interest’, this should constitute a valid agreement for the international interest. What if, instead of such an agreement, the parties present other documents which taken together may be construed as an agreement creating an international interest? In the absence of the written agreement for the international interest, can a certificate of registration of the international interest amount to such an agreement? As the Official Commentary to the Convention indicates, registration of the international interest does not amount to proof of the creation, the validity or even of the existence of the international interest.<sup>63</sup> Rather, the purpose of registration is to give public notice of the interest and to secure its holder’s priority in relation to third parties.<sup>64</sup> This position must be correct since the mere fact of registration may have limited informative value to a searching third party. For instance, the parties may agree to register a prospective interest of the creditor while they negotiate the terms of a secured loan. If all works well, there will be no need to re-register it as the international interest as it will be effective as such from the date of the initial registration.<sup>65</sup> Crucially, a person searching the International Registry will not be able to determine whether the interest is a prospective or a current international interest at the time of the search because the search certificate will simply state that the person named in it either has or intends to acquire an interest in the object.<sup>66</sup> The searching person can then ask the parties for more details.<sup>67</sup> On the other hand, if the negotiations do not result in the conclusion of the security agreement, the registration will simply be ineffective.<sup>68</sup> So too, if the lessee decides to purchase the wagons at the end of the lease, the international interest of the lessor will be discontinued even if its registration was not immediately discharged.<sup>69</sup> In this case, the person searching the Registry will not be able to determine whether the lessor still has a valid international interest in the object or whether the ownership in such object has already passed to the lessee. For these reasons the certificate of registration alone cannot amount to or

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<sup>63</sup> Goode (n 5) 47.

<sup>64</sup> Ibid 183.

<sup>65</sup> Ibid 22.

<sup>66</sup> Art 22(3), the Convention.

<sup>67</sup> Goode (n 5) 150.

<sup>68</sup> Goode (n 5) 47.

<sup>69</sup> Ibid 47.

substitute for a valid international interest. What if such a certificate is supported by other documents and correspondence of the parties? The secured creditor may present such documents as a list itemising the same assets of the debtor as indicated in the registration certificate, documents showing that the loan has been advanced to the debtor and correspondence between the parties negotiating the terms of the security agreement. Could such documents, taken together and supported by the registration certificate, amount to a written agreement for the international interest?

Since there is no case law under the Convention, it may be helpful to examine cases in domestic legal systems which may reveal relevant factual settings and considerations. For example, section 9-203 of Article 9 UCC prescribes that in order to create a valid security interest the following formal requirements must be met. In general, 1) a secured party must give value, 2) the debtor must have rights in the collateral, 3) there must be a security agreement describing the collateral and 4) either the security agreement must be in writing and signed by the debtor or there must be some other authenticating event. In relation to the requirement of writing, section 9-203 does not state whether the security agreement must be contained in a single document or whether a multiplicity of documents can be sufficient to create a valid security interest. Similar to the position under the Convention, a financing statement, which is the equivalent of the certificate of registration, cannot be equated with a valid security agreement.<sup>70</sup> This stems from the fact that the main function of the financing statement is to provide third parties with notice that a person who has filed its interest may have a perfected security interest in the collateral.<sup>71</sup> Therefore, a financing statement alone cannot establish that a security agreement was in fact entered into by the parties.<sup>72</sup> Furthermore, a financing statement, even if it is signed by both parties, does not, generally, express the debtor's intention to grant a security interest to the creditor.<sup>73</sup> The importance of such granting words was

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<sup>70</sup> *American Card Co. v H.M.H. Co.*, 97 R. I. 59, 196 A 2d 150 (1963); *Shelton v Erwin*, 472 F.2d 1118, 1120 (8<sup>th</sup> Cir. 1973); *Mitchell v Shepherd Mall State Bank*, 458 F 2d 700 (10<sup>th</sup> Cir. 1972); *In re Mancini Meat & Provision Co.*, 23 UCC Rep 1037, 1977 WL 25609 (D. Conn 1977); *Flores De New Mexico v Banda Negra International*, 155 B. R. 571, 20 UCC 2d 1353.

<sup>71</sup> *In the Matter of Numeric Corp.*, 485 F 2d 1328, 12 UCC 416 (1973), at 1331.

<sup>72</sup> *Ibid* 1332.

<sup>73</sup> *In Re John Oliver Co.*, 129 B.R. 1,15 UCC 2d 1031.

highlighted in *In re Arctic Air*.<sup>74</sup> In this case, a secured creditor claimed almost half of the proceeds of sale of its insolvent debtor's assets generated as a result of a public auction. In the absence of a written security agreement, the secured creditor presented a financing statement together with copies of invoices showing that goods were sold and delivered to the debtor. However, it was held that these documents could not amount to a valid security agreement as neither of them contained any language evidencing the intention of the debtor to grant a security interest to the creditor.<sup>75</sup> A different conclusion was reached in the case of *In the Matter of Numeric Corp.*<sup>76</sup> In this case, the parties intended to enter into a security agreement covering machinery of the debtor, but it could not be established whether such an agreement came into existence and whether it was signed. Instead, the creditor presented a financing statement covering the machinery coupled with the resolution of the directors of the bankrupt debtor itemising the same machinery and stating that a security agreement in favour of the creditor did in fact exist. It was held that these documents taken together were sufficient to create a valid security interest in favour of the creditor allowing it to claim the machinery in the bankruptcy proceedings.<sup>77</sup> The court stated that a separate formal document titled as a 'security agreement' was not always necessary for the purposes of section 9-203 UCC. The court identified two main purposes of the requirement of signed writing, namely to provide evidence as to precisely which objects were covered by the security interest and to serve as a Statute of Frauds, preventing the enforcement of claims based on wholly oral representations.<sup>78</sup> Provided that presented documents, even though not labelled as a security agreement, adequately describe the collateral and provide evidence of the agreement of the parties to create a security interest, these documents should satisfy the requirement of writing in section 9-203 and be amounted to a valid

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<sup>74</sup> 202 B.R. 533, 31 UCC 2d 233 (1996). For the same requirement of granting words in the context of oil and gas model agreements see F Rathert, 'Use of the Model Form Operating Agreement for the Creation and Enforcement of a Security Interest' (1986) 62 North Dakota L Rev 197, 205.

<sup>75</sup> See also *Gibbs v King*, 263 Ark 338, 564 S. W. 2d 515 (1978); *In re Cambridge*, 37 UCC Rep. 618, 34 B.R. 88 (1983); *In re Wolsky*, 68 B.R. 526 (1986); *In re Shinville Assoc., Inc.*, 46 B.R. 352 (1985).

<sup>76</sup> 485 F2d 1328, 13 UCC, 416 (1973).

<sup>77</sup> See also *Casco Bank & Trust Company v Cloutier*, 398 A. 2d 1224 (Supr.Jud.Ct.Maine 1979); *In re Rite-Cap*, 7 B.R. 113 (Bankr. R.I. 1980); *In re Frace*, 17 B.R. 198 (Bankr. D.Maine 1982).

<sup>78</sup> 485 F2d 1328, 13 UCC, 416 (1973), at 1331.

security agreement.<sup>79</sup> It follows that while a financing statement alone cannot substitute a valid security agreement, the position may be different when the financing statement is supported by other documents.<sup>80</sup> If such documents provide evidence that the parties intended to create a security interest and the collateral is adequately described in these documents and the financing statement, then these documents taken together can satisfy the requirement of writing of section 9-203.<sup>81</sup>

Since the purposes of the writing requirement of section 9-203 and the functions of financing statement appear to be similar to the purposes and functions of their equivalents under the Convention, it may be argued that the requirement of writing of Article 7 can, in principle, be interpreted in a similar way. This should not, of course, mean that the requirement of a written agreement for the international interest can be simply dispensed with. If the parties can produce a written agreement, no problem arises. But, in the absence of the written document, how can a creditor prove that the parties created an international interest in its favour? If the agreement cannot be presented, then the reasoning of cases such as *In the Matter of Numeric* would seem to be difficult to resist. If this view is correct, it would mean that although the certificate of registration signed by both parties alone cannot amount to a written agreement for the international interest, if other documents which identify the object in conformity with the Protocols and which, on the whole, express the intention of the parties to create the international interest are presented, then such documents, taken together with the certificate of registration, could constitute a valid agreement for the international interest. So if, in the absence of a written agreement, a creditor can produce a certificate of registration identifying the object of the debtor coupled with documents evidencing that the creditor has given a loan to the debtor and documents

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<sup>79</sup> Ibid 1331.

<sup>80</sup> Although the cases under Article 9 UCC, generally, support the view that in the absence of a written security agreement, a collection of documents disclosing intention to grant a security interest coupled with a financing statement signed by the parties can be sufficient to establish a valid security, the position may be less clear under the latest version of Article 9 (2009 edition). S. 9-502 of Article 9 does not require the debtor to sign the financing statement. In case of the unsigned financing statement it may be even more difficult to use it as evidence of the existence of a security agreement. See T Anderson, M Culhane, C Wilson, 'Attachment and Perfection of Security Interests under Revised Article 9: A 'Nuts and Bolts' Premier' (2001) 9 Am Bankr Inst L Rev 179, 188; Uniform Commercial Code: Official Text and Comments (n 16) 1004-1005.

<sup>81</sup> See also *In re Carmichael Enterprises, Inc.*, 334 F Supp. 94, 105 (N.D.Ga 1971); *Nunnemaker Transp. Co. v United Cal. Bank*, 456 F 2d 28 (9<sup>th</sup> Cir. 1972).

identifying the same object as the one listed in the certificate of registration, than taken together, these documents could probably be used to provide evidence that the parties intended to create the international interest in such object.<sup>82</sup>

At the same time, it can also be argued that the approach taken by the US courts cannot offer a workable solution in the context of the Convention. Since the Convention is an international instrument, it is likely to govern transactions involving parties from different jurisdictions. The courts in such jurisdictions may not always have a uniform understanding of the relative value of different documents. While some jurisdictions may treat a certificate of registration coupled with documents evidencing the advance of a loan as sufficient proof of the existence of the agreement of the international interest, the courts in other legal systems may insist on a single written agreement of the international interest. Furthermore, the high value of the equipment governed by the Convention may urge the parties concerned to solidify their agreement into a written form instead of relying on a multiplicity of various documents. The uncertainty in relation to whether a combination of documents can amount to a written agreement for the international interest and if so, what documents can serve this purpose may undermine the general principle of predictability under the Convention and lead to the increased transaction costs. To avoid these consequences, it may be advisable to conclude an integral written document for the international interest rather than to rely on a combination of various documents which can amount to such an agreement.

A preferred solution which appears to balance these two sets of conflicting considerations is the following. In cases where there is no written agreement for the international interest as such, the presumption should be raised that the writing requirement of the Convention is not met. In the light of the considerations set out in the previous paragraph, this presumption should be a strong one. It should then be for the creditor to rebut that presumption by presenting written documents showing that there is sufficient written evidence of the existence of the parties' agreement. This proposed solution gives sufficient weight to the explicit writing requirement and, at the same time, it takes account of the possibility that even

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<sup>82</sup> Art 20(1) of the Convention indicates that registration may only be affected, amended or extended by either party with consent in writing of the other party, which can prevent improper registrations. See Goode, Commentary (n 4) 207.

though there is no single written contract between the parties, there is sufficient documentary evidence showing the parties' intentions to create the international interest. In short, this position takes account of the concerns for certainty and predictability which underlie the writing requirement. At the same time, because the creditor is given an opportunity to rebut the presumption, the proposed solution avoids rigidity by introducing a mechanism for reaching a fair result in the circumstances.

c) The definition of 'writing' and the requirement of signature

'Writing' is defined as 'a record of information (including information communicated by teletransmission) which is in tangible or other form and is capable of being reproduced in tangible form on a subsequent occasion and which indicates by reasonable means a person's approval of the record.'<sup>83</sup> The definition of writing covers both traditional paper documents as well as electronic and other forms of communication.<sup>84</sup> Under this definition, a paper document is a 'record of information...in tangible form...' and an electronic document is a 'record of information ...communicated by teletransmission' which can be '...reproduced in tangible form on a subsequent occasion...'. Since both paper and electronic forms of communication are simply called a 'record' and are not subjected to different treatment under the Convention it can be assumed that they should have equal legal force.<sup>85</sup> It follows that an agreement for an otherwise valid international interest cannot be invalidated for a simple reason that it is not also put into a traditional written paper-based form. Provided that it can be 'reproduced in tangible form on a subsequent occasion,' such an agreement should still be valid. The explicit permission of the Convention to use electronically created and stored documents will probably be welcomed both by creditors and debtors. Already, some banks are exploring and using the possibility of granting loans online to the

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<sup>83</sup> Art 1(nn), the Convention.

<sup>84</sup> Goode (n 5) 153.

<sup>85</sup> This approach is also adopted by some other jurisdictions. For example, the Australian Electronic Transactions Act (1999) which follows UNCITRAL Model Law on Electronic Commerce (1996) and the United States Electronic Signatures in Global and National Commerce Act (2000) give both paper based and electronic documents equal legal status. See S Christensen, S Mason, K O'Shea, 'The International Judicial Recognition of Electronic Signatures – Has Your Agreement Been Signed?' (2006) Communications Law 150.

debtors.<sup>86</sup> Similarly, in some cases, equipment can be leased to the lessees using online electronic lease forms.<sup>87</sup> Taking into account the international nature of the transactions covered by the Convention, the possibility of conducting business electronically may be more efficient than creating an agreement by means of traditional paper documents, since electronic documents can usually reach the recipient faster than their paper versions. The Official Commentary does not give any examples of what can be considered as ‘electronic and other forms of teletransmission’.<sup>88</sup> Presumably, a copy of an agreement for the international interest contained on a floppy disc, a USB memory stick, a compact disk or on a hard drive which can be printed out whenever required by the parties should fall within the definition.<sup>89</sup> This is probably also true about agreements for international interests negotiated and concluded by e-mail. In this case, such an agreement can simply be stored in the electronic form and will not have to be transferred into a tangible form in order to become valid.

Article 7 does not state whether the written agreement for the international interest has to be signed and if so, whether both parties must sign it. The definition of writing of Article 1(nn), however, makes it clear that regardless of whether the agreement for the international interest is contained in a paper or electronic document, it will have to indicate ‘by reasonable means a person’s approval of the record’. Since signature is probably the most natural or reasonable way of indicating one’s approval of the content of the document, it is probably safe to say that the agreement for the international interest must be signed in order to be valid.<sup>90</sup> The only reason why the Convention does not specifically refer to a signature probably flows from the desire to ensure that electronic and not merely conventional signatures are also covered.<sup>91</sup>

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<sup>86</sup> W Agin, ‘Electronic Signatures and Instruments’ (2005) 1 J Bankr L Practice 2.

<sup>87</sup> Ibid 2.

<sup>88</sup> Goode (n 5) 153.

<sup>89</sup> The position is similar under the UCC under which electronic mail, audio tapes, photographic media as well as digital voice messaging systems are considered as a ‘record’ and have the same legal effect as traditional paper documents. See White and Summers (n 16) 755.

<sup>90</sup> This view can be supported by the Official Commentary to the Convention. See Goode (n 5) 153.

<sup>91</sup> The Revised Article 9 UCC also abandons the requirement of signed writing. Instead the debtor should ‘authenticate’ the agreement. Such language is said to better reflect the needs of commerce in the age of electronic transactions. See L Ahern, ‘“Workouts” Under Revised Article 9: A Review of Changes and Proposal for Study’ (2001) 9 Am Bankr Inst L Rev 115, 144.

If the view that the agreement must be signed is correct, then it is regrettable that Article 7 does not explicitly say so. A signature placed at the foot of the document conveys a certain degree of completeness and finality to the document. The parties to an agreement usually sign it after all terms of the agreement have been discussed and agreed upon. A signature at the end of the document can also signify the intention of the parties to be committed to the performance of the agreement. Conversely, an unsigned document may mean that it is not final and some terms will have to be further negotiated, or that one of the parties was not certain whether it should accept the responsibilities arising under the agreement. Furthermore, in the absence of the express requirement of signature under Article 7, the parties may presume that there is no need to sign an agreement in order to make it valid in the eyes of the Convention. The fact that signature is required only becomes apparent after Article 1(nn) is examined. This may create, so to speak, a hidden validity requirement, which could have been avoided had Article 7 expressly indicated that the written agreement for the international interest must be signed.

Article 1(nn) does not indicate whether both parties must sign the document. This may also lead to some confusion as parties operating in different jurisdictions may have their own understanding on this matter. For instance, while section 9-203 UCC requires that only the debtor should ‘authenticate a security agreement’, the Russian Law on Pledges merely states that the security agreement must be put into a written form without any indication whether it should be signed.<sup>92</sup> This uncertainty may lead to unnecessary litigation where, for instance, one of the parties claims that a written agreement for the international interest is not valid and a conditional seller cannot take possession of the object because the retention of title agreement was only signed by the debtor and not by the creditor. To avoid the costs associated with such uncertainty and litigation, it may be advisable to require both debtor and creditor to sign the agreement in order to ensure its validity. Perhaps certainty is best achieved if the creditor and the debtor are required to put their signature because both of them are parties to the contract undertaking their respective rights and obligations.

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<sup>92</sup>Art 10, Russian Federation Law on Pledges of 29.05.1992, N 2872-1 (with variations adopted by Federal Law of 16.07.1998 N 103-Φ3).



Since the definition of writing encompasses both paper and electronic documents, the person's approval of the record can probably be indicated by means of manual and/or electronic signature.<sup>93</sup> The Convention does not impose a requirement that a signature should be unique in order to ensure that the person whose name is placed at the end of the document is the person who actually signed it or authorised another person to sign it on its behalf. This means that in the case of electronic documents, there will be no need to sign it by means of a digital signature and, in principle, any other type of electronic signature will probably be sufficient for the purposes of the Convention. Generally speaking, an 'electronic signature' is a generic term which is used to describe signatures incorporated into documents by electronic means.<sup>94</sup> Examples of electronic signatures include the typed-written name of the signing person at the foot of the e-mail<sup>95</sup> and where the name of the person sending the email does not appear at the end of the document, the requirement of signature may be satisfied by the header of the email bearing the sender's name.<sup>96</sup> Other examples of electronic signature include scanned version of manual signature incorporated into a document and clicking of an 'I Accept' button which can be found at the end of some web pages.<sup>97</sup> In contrast, digital signatures are types of electronic signatures which can be unique to their users and are capable of protecting the data from non-authorised use by third parties.<sup>98</sup> Digital signatures usually involve the use of complementing asymmetric keys: one private key which is unique to the sender and one public key which is given to the recipient and enables it to open and read the electronic document as well as to determine whether it was interfered with in the process of transmission.<sup>99</sup> In order to be able to use such a digital signature, the signing person will have to gain access to the private and public keys which can be purchased from companies dealing with such products.<sup>100</sup> Since digital signatures are not yet widely used worldwide and are not expressly required by

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<sup>93</sup> Goode (n 5) 153.

<sup>94</sup> Christensen, Mason, O'Shea (n 85) 151.

<sup>95</sup> *Faulks v Cameron* (2004) 32 Fam LR 417; *Wilkens v Iowa Insurance Commissioner*, 457 NW 2d 1 (1990).

<sup>96</sup> *International Casings Group Inc v Premium Standard Farms Inc*, 358 F Supp 2d 863 (2005).

<sup>97</sup> Christensen, Mason, O'Shea (n 85) 151.

<sup>98</sup> P Cerina, 'The New Italian Law on Digital Signatures' (1998) *Computer and Telecommunications L Rev* 193, 194.

<sup>99</sup> *Ibid* 196.

<sup>100</sup> D Capps, 'Conveyancing in the 21<sup>st</sup> Century: An Outline of Electronic Conveyancing and Electronic Signatures' (2002) *Conveyancer and Property Law* 443, 449.

Article 1(nn), it seems that an electronic rather than digital signature should be sufficient for the purposes of the Convention. Similarly, in the case of paper documents, there is no requirement that signature should be unique to the signing person. This may mean that while usual manual signatures are included, typed-written name at the end of the document will probably also be sufficient for the purposes of Article 1(nn) and 7 of the Convention and will not be required to be witnessed by a third party or supported by notarial certificate to ensure its authenticity.<sup>101</sup>

#### d) The content of the agreement

Although Article 7 prescribes that an agreement for the international interest must be put into a written form, it does not state that it should be labelled in a certain way. Furthermore, there is no requirement that such an agreement must contain any specific terms in order to be valid.<sup>102</sup> With respect to the label, it means that the agreement need not be titled as the ‘agreement for the international interest’ and parties can title it either as a charge, a mortgage, retention of title agreement or in any other suitable way. This corresponds to the approach taken by Article 2 of the Convention whereby a transaction is first characterised either as a security, retention of title or a lease under the applicable domestic law and, secondly, if it corresponds to the definitions of these categories under Article 1 of the Convention, it can be brought under the umbrella of the international interest. In this way, the Convention recognises that the same transaction may be labelled differently by various jurisdictions and as far as it still falls into the definition of a security, retention of title or a lease under Article 1 it can be governed by the Convention.<sup>103</sup>

Apart from the terms relating to the identification of the object, the power to dispose and the nature of the secured obligations, there is no requirement that the agreement for the international interest must contain certain terms in order to be

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<sup>101</sup> The position is different under Hungarian law whereby a security agreement should be incorporated into a notarised document. See O Boronyai, ‘Hungary: Security For Lending - Reforms’ (1995) JIBL 69.

<sup>102</sup> Some legal systems require a security agreement to be put into standard form in order to be valid. See M Laurence, ‘Argentina: Security – Rights of Sellers’ (1998) Int’l Comp and Com L Rev 11, 12.

<sup>103</sup> Goode, Commentary (n 4) 168.

valid. This means that it is for the parties to decide what should be included in their agreement and it will not be invalidated if such an agreement does not stipulate what is the maximum period for the repayment of the loan or what is the value of the collateral under a security agreement. This position of the Convention may be contrasted with some other legal systems which specify what terms must be included in a security, retention of title or a lease agreement. For instance, Chinese law requires a security agreement to be executed in a written form and to contain a specified list of terms.<sup>104</sup> Such an agreement must, among other things, indicate the period of the repayment of the loan, who is in the possession of the collateral, the uses to which the loan will be put, the means of resolving disputes and the date and place where the contract was signed.<sup>105</sup> The Russian Law on Pledges also requires a security agreement to be put into a written form and to contain prescribed terms.<sup>106</sup> So, the type of the pledge as well as the value of the collateral must be specified.<sup>107</sup> In addition, the nature, value and the period of performance of the secured obligation must also be indicated in the security agreement.<sup>108</sup> Although Article 7 does not have similar requirements with respect to the content of the agreement, it is suggested that such an agreement should at least reflect the nature of the transaction. Thus, it may express the intention of the chargor to transfer to the chargee its interest in the collateral by way of security or to state that ownership in the object will not pass from conditional seller to the buyer until fulfilment of certain conditions. Alternatively, the agreement may provide that the lessor grants a right to possession of the object to the lessee in return for rental payments. This suggestion should follow from the fact that Article 2 of the Convention defines international interest through the concepts of security interest, retention of title and lease. Consequently, the agreement creating the international interest should reflect the nature of the transaction upon which it is based. Furthermore, the indication whether the transaction is characterised by domestic law as a security, retention of title or a lease is essential for the purposes of remedies under the Convention. The characterisation of a transaction and the

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<sup>104</sup> M Riley, 'Borrowing with Security in China' (1995) JIBL 428, 430.

<sup>105</sup> G Yu, 'The Law of Pledges in the People's Republic of China' (1996) 14 UCLA Pacific Basin L J 270, 274-275.

<sup>106</sup> W Frenkel, 'New Russian Secured Transactions Regime: Analysis of the Law on Pledge' (1993) JIBL 186, 187.

<sup>107</sup> Art 10, Russian Federation Law on Pledges of 29.05.1992, N 2872-1 (with variations adopted by Federal Law of 16.07.1998 N 103-Φ3).

<sup>108</sup> Ibid Art 10.

reflection of its nature in the agreement of the international interest is the only way to determine which remedies may be available to the parties under the Convention. While a secured creditor can exercise the remedies available to it under Article 8 and Article 9, conditional seller and lessor can only resort to the remedies under Article 10 of the Convention. This direct link between the characterisation of a transaction and the remedies available to the creditor suggest that the agreement for the international interest must indicate whether the interest of the creditor was created as a result of a security agreement, or was retained by it under retention of title or a leasing agreement. The suggestion that the type of the transaction should be indicated in the agreement for the international interest may further be supported by the requirement of Article 7(d) of the Convention stipulating that in the case of the security agreement, the latter must determine the nature of the secured obligation although the sum or a maximum sum which it secures need not be stated. So, the agreement may provide that the secured creditor agrees to lend funds to the debtor for the purpose of acquiring an aircraft engine without specifying the maximum amount of the loan. Since the nature of the secured obligation (i.e. the repayment of the loan) is indicated in the security agreement, such an agreement must necessarily express the intention of the chargor to transfer the interest in an object to the chargee as a security for the performance of such secured obligation (i.e. that the debtor agrees to transfer its interest in the aircraft engine to the secured creditor by way of security for the repayment of the loan). This term will be needed because in order to create a valid security interest, the parties have to allocate a particular asset of the debtor to the repayment of the debt.<sup>109</sup> For instance, if the creditor provides an airline with a loan to enable it to buy specific models of aircrafts, this will not in itself create an international security interest in these aircrafts for the benefit of the creditor. To create such an international interest in these objects, the agreement between the parties will have to state that the debtor agrees to transfer its interest in the aircrafts to the creditor for the purpose of securing the repayment of the loan. In the absence of such a provision, the creditor is unlikely to receive any proprietary interest by way of security in the aircrafts of the debtor.

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<sup>109</sup> Gullifer (n 7) 1-16.

Other terms which must be present in a valid agreement for the international interest relate to the debtor's power to dispose of the object, the identification of the object and in the case of the security agreement, the nature of the secured obligation. These terms will be considered below.

## 2.2 '*Power to dispose*'

### 2.2.1 General

When the debtor defaults in repayment of the loan, the secured creditor may decide to enforce its security interest. At this point the secured creditor may learn that the aircraft which the parties agreed to use as collateral was only delivered to the debtor on a trial basis or to do some repair works. Alternatively, the creditor may learn that the debtor merely had a right to possession of the aircraft as a lessee under a leasing agreement with a third party, or that it was delivered to the debtor under a conditional sale agreement and the ownership did not pass to the debtor because the purchase price for the object was not fully paid. In these circumstances the secured creditor intending to take possession and sell the aircraft may be confronted by its true owner claiming that the aircraft should be returned to it. The owner may argue that the debtor did not have the power to dispose of the object in a way that would allow it to grant a security interest in the aircraft to the creditor. Since the debtor did not have the power to dispose of the object, the security interest of the creditor did not attach to the aircraft.<sup>110</sup> For this reason, the object should be returned to its true owner.

To prevent such an outcome, a prudent secured creditor would have to clarify whether the debtor has a right or power to dispose of the object which it offers as a security for the repayment of the loan before extending the funds. If the debtor is the owner of the object or has power to dispose of it in some other capacity, then the secured creditor's interest can attach to this object. In other words, in case the security interest will have to be enforced, the secured creditor

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<sup>110</sup> This is in line with a widely accepted principle of *nemo dat quod non habet* which is translated as 'no one can give what they do not have'. See H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (Oxford, OUP 2007) 407. This principle is often subjected to exceptions in various legal systems. For examples of such exceptions under English law see s. 24, 25 Sale of Goods Act 1979; s. 9 Factors Act 1889; s. 27 Hire Purchase Act 1964.

will be able to assert its right in this particular object. On the other hand, if the debtor has not got a proprietary interest in the object, it will not have the power to dispose of it and no security can be created in relation to it. It is for this reason that the Convention requires an agreement for the international interest to relate to the object of which the chargor, conditional seller or lessor has power to dispose.<sup>111</sup> In general terms, this requirement means that in order to be able to use an object as a collateral or to sell or lease it, the chargor, conditional seller or lessor should have some interest in this object, which may amount to ownership or lesser interests.<sup>112</sup>

### 2.2.2 The power to dispose under the Convention

The power to dispose includes the right to dispose, that is, where the chargor, conditional seller or lessor are owners of the object or have authority of the owner to deal with it.<sup>113</sup> For instance, a manufacturer (and owner) of train wagons, can grant a security in these objects to a creditor to secure the repayment of the loan. If the manufacturer defaults, the secured creditor can, in principle, obtain discharge of the debt from the sale of the collateral. Similarly, if a head lease of an airframe allows the lessee to create a sub-lease or grant a security in the object, the lessee can grant a security in this airframe to a secured creditor. This disposition will bind the head lessor to the extent of the interest held by the lessee. In the case of the lessee's default, the secured creditor will be able to enforce its security by stepping into the shoes of the lessee, but will not be able to displace the lessor as the new owner.<sup>114</sup> Provided that the rental payments to the head lessor are continued, the secured creditor can, for example, grant a sub-lease to a third party and obtain its discharge from the rentals received under the sub-lease.

But the power to dispose is wider than the right to dispose and covers other situations whereby a non-owner chargor, conditional seller or lessor can deal with the object in such a way that it will bind the true owner even if the latter did not

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<sup>111</sup> Art 7(b), the Convention.

<sup>112</sup> Goode (n 5) 162.

<sup>113</sup> Ibid 162.

<sup>114</sup> For a similar example see D Baird and T Jackson, "Possession and Ownership: An Examination of the Scope of Article 9" (1982-83) 35 *Stan L Rev* 175, 203, n 85.

authorise the disposition.<sup>115</sup> The Convention does not explain in what circumstances the power to dispose will arise. The Official Commentary, however, suggests that it may arise either under the applicable domestic law or under the Convention.<sup>116</sup> If the power to dispose can be established under the applicable law, there is no need to see whether such power is also conferred by the Convention.<sup>117</sup>

The Convention's rules on priority may help identify the circumstances in which the power to dispose may arise.<sup>118</sup> For example, the Convention states that a registered interest has priority over any other interest subsequently registered and over an unregistered interest.<sup>119</sup> If the debtor grants a security by way of transfer of ownership in a locomotive to the secured creditor 1 (SC1) who does not register its interest, and then grants a similar security to the secured creditor 2 (SC2) who immediately registers its interest, SC2's interest will take priority over the unregistered interest of SC1 even though the latter was the first to be granted the security by the debtor. The rule that the registered interest prevails over the unregistered one shows that the debtor can have the power to dispose of the interest even if the transferred interest is greater than the one which it holds.

Had SC1 registered its interest, the outcome would have been different. Suppose the debtor owns 50% of a new locomotive worth £2m so that the debtor's fraction of ownership amounts to £1m. The debtor transfers its interest by way of security to SC1, who registers its interest, to secure the repayment of £200,000 of loan. The debtor also grants a security to SC2, who registers its interest, to secure another £500,000 of loan. On the debtor's default, the secured creditors will be able to enforce their respective security interests in the order of registration. Once the locomotive is sold, SC1 will be the first to obtain the discharge, followed by SC2. Any remainder of the proceeds of sale will go back to the debtor. Since SC1 registered its interest, the debtor was only able to transfer to SC2 the interest which it held, namely, its fractional ownership in the locomotive subjected to the security of SC1.

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<sup>115</sup> Goode (n 2) 24.

<sup>116</sup> Goode, Commentary (n 4) 176.

<sup>117</sup> Goode (n 22) 13.

<sup>118</sup> Goode, Commentary (n 4) 176.

<sup>119</sup> Art 29(1). See also R Goode, "The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing" (2003) 36 UCC L J 2 Art 1.

It has been suggested that the rule that the registered interest prevails over subsequently registered and unregistered interests may mean that the lessee or the conditional buyer can have power to dispose of the object.<sup>120</sup> According to this view, if a lessor does not register its interest, and the lessee wrongly grants a security in the object to a secured creditor who registers its interest, the unregistered interest of the lessor may be postponed to the registered interest of the secured creditor. Since the secured creditor may be able to enforce its security in the object of the lease, it follows that the lessee had sufficient power to dispose of its interest in that object.<sup>121</sup> Similarly, a conditional seller may deliver possession of the train wagons to the buyer and fail to register its interest before the buyer improperly grants a security interest in them. If the secured creditor registers its interest before the conditional seller, the subsequently registered interest of the conditional seller may be subordinated to the previously registered interest of the secured creditor. The Convention seems to implicitly allow this outcome by preferring the registered interest to the initially unregistered but subsequently registered interest. It seems to follow that although the Convention does not expressly state that the conditional buyer has the power to dispose, the fact that the registered interest of the secured creditor can be preferred to the unregistered or subsequently registered interest of the conditional seller, may mean that the conditional buyer has sufficient power to dispose of the object in favour of the secured creditor.

Although this argument is an attractive one, it fails to explain whether the lessee and the conditional buyer have the power to dispose in the first place. It is true that the registered interest prevails over the unregistered or subsequently registered interest. But to make a valid registration, it is not sufficient to simply register whatever interest the lessee<sup>122</sup> purports to transfer to the secured creditor. The secured creditor may register its interest as many times as it thinks fit, but the truth remains: unless the lessee had the power to dispose of the interest in the first place, the registration by the secured creditor will simply be ineffective. If this is the case, the registered security interest will not be subordinated to the subsequently registered interest of the lessor. The mere fact of registration cannot

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<sup>120</sup> Goode (n 2) 24.

<sup>121</sup> Ibid 24.

<sup>122</sup> This discussion is equally relevant to the positions of conditional seller and buyer.



prove that the lessee had sufficient power to dispose of its interest in the object. This argument also appears to be circular: to show that the lessee had the power to dispose in favour of secured creditor, one has to demonstrate that by registering its interest before the lessor, the secured creditor obtains priority. But the effectiveness of priority and the validity of registration of the secured creditor's interest depend on whether the lessee had sufficient power to dispose of its interest in the object. If the lessee did not have such power, the security interest will simply not attach and its registration will not be effective.

This does not mean that the interest of the secured creditor which was registered before the interest of the lessor will never gain priority. But to achieve this result, the lessee must, first of all, obtain the power to dispose of its interest in the object.

It has been argued that the lessee should be treated as having the power to dispose simply because the Convention requires the lessor to register its interest.<sup>123</sup> On this view, the registration is essential to protect the lessor from adverse disposition by the lessee.<sup>124</sup> Since such adverse disposition is possible, it must mean that the lessee has sufficient power to dispose.<sup>125</sup> However, the possibility of non-authorised disposition by the lessee is not the only reason why the lessor may decide to register its interest. Suppose that the lessor delivers possession of an airframe to the lessee. Following the delivery, the lessor grants a charge over the airframe to a secured creditor. On the lessor's default, the secured creditor approaches the lessee in order to take possession of the airframe. The outcome of the priority dispute between the secured creditor and the lessee will depend on whether and when the lessor has registered its interest.<sup>126</sup> If the lessor has registered its interest before the secured creditor, the lessee's interest will be protected.<sup>127</sup> Conversely, if the lessor did not register or registered after the secured creditor, the latter will be able to take possession of the airframe.<sup>128</sup> Since protection against possible non-authorised disposition by the lessee is not the only reason why the lessor may need to register its interest, the requirement of registration alone cannot prove that the lessee has the power to dispose.

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<sup>123</sup> Goode (n 2) 24.

<sup>124</sup> Ibid 24.

<sup>125</sup> Ibid 24.

<sup>126</sup> Art 29(4).

<sup>127</sup> Art 29(4)(b).

<sup>128</sup> Art 29(4)(a).

This discussion does not mean that the lessee<sup>129</sup> will never have the power to dispose under the Convention. For example, it can be implied from Article 29(3) that in the cases of sale to a third party buyer, the lessee may have sufficient power to dispose of its interest in the object.

This suggestion follows from the Convention's rule that a buyer of an object can acquire its interest in it free from an unregistered interest even if it had actual knowledge of it.<sup>130</sup> Suppose a lessor delivers possession of the train wagon to the lessee and fails to register its interest. If the lessee wrongly sells the wagon to the buyer, the latter will acquire its interest in it free from the unregistered interest of the lessor. As a result, the buyer will subordinate the interest of the lessor as the new owner of the wagon even if it had actual knowledge of the lessor's interest in it.<sup>131</sup> This means that the lessee, who only has a right to possession of the wagon and not the ownership of it, can transfer to the buyer an interest which is greater than the one that the lessee held. Moreover, this non-authorised disposition will be binding on the lessor who did not register its interest in the object. Since the lessee is able to transfer an interest in the object to the buyer, it should follow that the lessee, under such circumstances, has sufficient power to dispose for the purposes of Article 7.<sup>132</sup>

This reasoning need not be confined to the position of the lessee, since the sale to the buyer could have been negotiated by a chargor or a buyer under a reservation of title agreement. Suppose an owner of a locomotive charges it to a secured creditor under a security agreement whereby all dispositions of the collateral must be approved by the secured creditor. Before the secured creditor registers its interest, the chargor wrongly sells the locomotive to a buyer. Since the secured creditor failed to register its interest before the sale, the buyer will take the interest in the locomotive free from the interest of the secured creditor.<sup>133</sup> Similarly, if the buyer under a title reservation agreement sells the equipment to a sub-buyer before the conditional seller registers its interest, the sub-buyer will be able to subordinate the interest of the conditional seller as the new owner of the

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<sup>129</sup> This is also applicable to the position of conditional buyer.

<sup>130</sup> Art 29(3)(b).

<sup>131</sup> Goode (n 5) 214, Illustration 21.

<sup>132</sup> For a similar view see Goode, Commentary (n 4) 225.

<sup>133</sup> Art 29(3)(b).

object.<sup>134</sup> It follows that if the secured creditor, the lessor or the conditional seller do not register their interests, the chargor, the lessee or the conditional buyer will have sufficient power to dispose of their interests in the object to the sub-buyer. The position would have been different had the secured creditor, the lessor or the conditional seller registered their respective interests in the International Registry.<sup>135</sup> In this case, the sub-buyer can only acquire an interest in the equipment subject to the interests registered at the time of the acquisition.<sup>136</sup> It follows that unless the transferor was authorised by the holder of the registered interest to sell the object to the buyer, the transferor will not have sufficient power to dispose of it free from such registered interest. Consequently, the sub-buyer will only be able to step into the shoes of the transferor and will not be able to subordinate the registered interest of the party from whom the transferor held its interest.

### 2.2.3 The power to dispose under the applicable domestic law

The power to dispose can also arise under the applicable domestic law. For instance, Article 9 UCC prescribes that the debtor under a security agreement must have rights in the collateral or the power to transfer rights in the collateral to the secured creditor.<sup>137</sup> The UCC does not explain what rights in the collateral or power to transfer rights in the collateral amount to.<sup>138</sup> It has been suggested that this requirement is sometimes invoked by the courts to solve priority disputes between various creditors of the defaulting debtor<sup>139</sup> and that it should probably be abandoned.<sup>140</sup> While, as a general rule, a transferor cannot transfer to the transferee more than it has,<sup>141</sup> a mere naked possession of the object will not

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<sup>134</sup> Art 29(3)(b).

<sup>135</sup> Art 29(3)(a).

<sup>136</sup> Art 29(3)(a).

<sup>137</sup> S. 9-203(b)(2) Article 9 UCC.

<sup>138</sup> For a proposed definition of what should these terms mean under the UCC see M Thomson, 'Those Calves Are Mine: Toward a Uniform Commercial Code Definition of 'Rights in the Collateral'' (2008) 53 South Dakota L Rev 74, 98-99; W Hogan, 'Future Goods, Floating Liens and Foolish Creditors' (1965) Stan L Rev 822.

<sup>139</sup> J Turner, 'Rights in Collateral under UCC s 9-203' (1989) Miss L Rev 677.

<sup>140</sup> M Livingston, 'Certainty, Efficiency, and Realism: Rights in Collateral under Article 9 of the Uniform Commercial Code' (1994) North Carolina L Rev 115.

<sup>141</sup> *Charter Bank of London v Chrysler Corporation*, 115 Cal. App. 3d 755, 171 Cal. Rptr. 748, 30 UCC 1438. In this case the dealer of the manufacturer of boats, who did not have possession or a right to possession of the boat wrongly purported to sell it to a buyer. Since the dealer did not have

satisfy the requirement of the rights in the collateral.<sup>142</sup> Thus, if the equipment is given by the owner to the debtor on an experimental or trial basis, the debtor does not acquire rights in the equipment which are sufficient to enable it to grant a security interest to a secured creditor in such equipment and it will have to be returned to the true owner.<sup>143</sup> At the same time, if the naked possession of the object is coupled with something more, than it can constitute sufficient rights in collateral which, in turn, will enable the security interest of the secured creditor to attach to this object.<sup>144</sup> This additional requirement may amount to a certain degree of control which the debtor in possession is able to exercise over the object<sup>145</sup> and to the intentions of the parties.<sup>146</sup> Alternatively, it may amount to a certain ‘quantum of rights’ whereby the debtor is given the power to transfer a good title in the goods to a third party.<sup>147</sup> On this basis, a true lease can be distinguished from a lease by way of security under the UCC.<sup>148</sup> In case of a true lease, the lessor remains the owner of the object and, as a result, a lessee does not acquire any rights in collateral for a security to attach.<sup>149</sup> By contrast, in a lease

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ownership or possession of the boat, it could not transfer to the buyer a title which was greater than what it held. Consequently, the buyer did not have any rights in the boat which he could transfer to the Bank by way of security. Since the buyer did not have rights in the collateral, the security interest of the Bank could not attach to the boat and the manufacturer of the boat was able to resist its claim. See also *Georgia- Pacific Corporation v Walter E. Heller & Company Southeast, Inc.*, 440 So. 2d 666, 37 UCC 735. This case can serve as an example of an exception to the general rule whereby a non-owner was held to be able to transfer the title greater than the one it held.

<sup>142</sup> *State Bank of Young America v Wagener*, 479 N.W. 2d 92, 16 UCC 2d 1189 where it was held that when the bailee takes possession of the collateral and ownership remains with the bailor, the bailee does not have sufficient rights in the collateral for the security interest of its creditor to attach. See also *In re Woods Farmers Cooperative Elevator Co*, 107 B.R. 678, 10 UCC 2d 474.

<sup>143</sup> *In re Shamrock Coal Company*, 47 B.R. 867, 40 UCC 786.

<sup>144</sup> *Morton Booth Company v Tiara Furniture, Inc.*, 564 P. 2d 210, 1977 OK 45 where it was held that the debtor had rights in raw materials of their owner because of the degree of control which the debtor could exercise over them. Under its contract with the owner of the raw materials, the debtor was required to use them in the process of manufacturing new products which would then be sold back to the owner.

<sup>145</sup> *Brown v Farmers Home Administration of the Department of Agriculture*, 622 F. Supp. 1047, 41 UCC 646, where the debtor in possession was held to have more than mere possession because he was able to mix the livestock of the owner with its own and was free to choose the place, price and time of sale of such livestock.

<sup>146</sup> *Union Bank of Hazen v Cook*, 63 B.R. 789, 1 UCC 2d 1660; *Rohweder v Aberdeen Production Credit Association*, 765 F. 2d 109, 41 UCC 77.

<sup>147</sup> R Anzivino, ‘When Does a Debtor have Rights in the Collateral under Article 9 of the Uniform Commercial Code?’ (1977-78) 61 *Marquette L Rev* 23, 44.

<sup>148</sup> The same reasoning applies to conditional sales. Anzivino (n 147) 27-32. The issue of distinguishing a true lease from a lease by way of security in the US law involves, of course, other more complicated issues and considerations. For the significance of this distinction in the context of taxation see S Austen, ‘Aircraft Financing in the United States: An Aerial View’ (1994) *Air & Space Lawyer* 10.

<sup>149</sup> *Disch v Raven Transfer & Storage Co.*, 17 Wash App. 73, 561P.2d 1097, 21 UCC 615 (1977).

amounting to security interest, the lessee is treated as a disguised conditional buyer and is able to transfer good title to a third party.<sup>150</sup> Consequently, the lessee is treated as having sufficient rights in the collateral and can grant a security interest in the object of the lease.<sup>151</sup> It follows that if a transaction is characterised under the UCC and brought into the Convention as a true lease, than, provided that the issue is not covered by the Convention itself, it can be found that a lessee does not have power to dispose of the collateral. Conversely, if the transaction in question is brought to the Convention as a lease by way of security, than the lessee may be found to have sufficient power to dispose of the object in favour of the secured creditor.

### 2.3 '*Object identified in conformity with the Protocol*'

#### 2.3.1 General

An agreement constituting the international interest must enable the object to be identified in conformity with the Protocol.<sup>152</sup> The Convention itself does not establish any criteria for identification of mobile equipment. It merely states that an international interest is an interest in mobile equipment in a uniquely identifiable object of one of the categories listed in the Convention.<sup>153</sup> These categories are presently comprised of a) airframes, aircraft engines and helicopters; b) railway rolling stock; and c) space assets.<sup>154</sup> The categories currently listed in the Convention may be added to by future Protocols.<sup>155</sup> In order to determine whether an object falls into one of the categories and how should the object be identified for the purposes of the Convention the parties to the agreement for the international interest must refer to more detailed and technical criteria of the Protocol which is relevant to their transaction.<sup>156</sup> The requirement

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<sup>150</sup> Anzivino (n 147) 27-32.

<sup>151</sup> Ibid 27-32.

<sup>152</sup> Art 7(c), the Convention.

<sup>153</sup> Art 2(2), the Convention.

<sup>154</sup> Art 2(3), the Convention.

<sup>155</sup> Art 51, the Convention. It was recently proposed to initiate preliminary work on a future Protocol relating to matters specific to agricultural, construction and mining equipment. See Luxembourg Resolution N 5 relating to Article 2(3) and Article 51 of the Convention on International Interests in Mobile Equipment.

<sup>156</sup> J Atwood, 'The Status of the Mobile Equipment (Cape Town) Convention – Arrival of an International Registration System' (2006) 39 UCC L J 1 Art 3.

of identification of the object raises several issues which will be considered in the following sections.

### 2.3.2 The objects covered by the Protocols<sup>157</sup>

#### a) Aircraft objects

One feature which is common to all Protocols in relation to the identification of objects is that the definitions of these objects not only describe their nature, but also help to determine which objects are covered by the Convention and the Protocols and which objects are likely to be excluded from their scope.<sup>158</sup> In relation to aircraft objects, Article I(2) and Article VII of the Aircraft Protocol provide the definitions of such objects and the essential elements of their description which are relevant for the constitution and registration of the international interest. The term ‘aircraft object’ is a generic term used by the Protocol to describe all types of objects listed in Article 2(3)(a) of the Convention, namely, aircraft frames, aircraft engines and helicopters.<sup>159</sup>

‘Airframes’ mean aircraft frames (other than those used in military, custom or police services) that are of such type as certified by the competent aviation

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<sup>157</sup> The Space Protocol is still under development and its final text is not yet available. The issue of the definition and identification of space property has proved to be a challenging one. Article 1.2(f) of the (Draft) Space Protocol defines space objects as 1) any separately identifiable asset that is in space or that is intended to be launched and placed in space or has been returned from space; 2) any separately identifiable component forming a part of an asset or attached to or contained inside the asset; 3) any separately identifiable asset assembled or manufactured in space and 4) any launch vehicle that is extendable or can be reused to transport persons or goods to and from space. So space objects will not be confined only to satellites or space objects which are located in space. It was suggested that the definition of space objects should include such equipment as transponders, frequencies, antennas and other objects attached or allocated to a space object. Realising that in the case of the debtor’s default it may be difficult or impossible to take possession of the space object orbiting the Earth, the Protocol will use the notion of associated rights to include any licences, authorisations or permits issued by relevant national authorities enabling the holder of such associated rights to have control over the space object. The issue of definition of space objects was much debated because of its connection to the issues of public interest and national security of the Contracting States. For general information on the (Draft) Space Protocol see O Ribbenik, ‘The Protocol on Matters Specific to Space Assets’ (2004) 1 Unif L Rev 37; D Panahy and R Mittal, ‘The Prospective UNIDRIT Convention on International Interests in Mobile Equipment as Applied to Space Property’ (1999) 2 Unif L Rev 303; P Larsen, ‘Future Protocol on Security Interests in Space Property’ (2002) 67 J Air L Com 1071; P Larsen and J Heilbock, ‘UNIDROIT Project on Security Interests: How the Project Affects Space Objects’ (1998-99) 64 J Air L Com 703; S Davies, ‘Unifying the Final Frontier: Space Industry Financing Reform’ (2001) 106 Comm L J 455.

<sup>158</sup> Goode, Commentary (n 4) 12; J Roberts, J Carruth, W Stuber, M Sundahl, ‘International Secured Transactions and Insolvency’ (2005) 40 Int’l Lawyer 381, 389.

<sup>159</sup> Art I(2)(c), the Aircraft Protocol.

authority to transport i) at least eight persons including crew or ii) goods in excess of 2750 kilograms together with all installed, incorporated or attached accessories, parts and equipment (excluding aircraft engines) and all data, manuals and records relating to the aircraft.<sup>160</sup> The Protocol uses the test of minimum carrying capacity of the aircraft (persons or weight of cargo) in order to exclude smaller airframes from the Convention and to confine its application to high value objects.<sup>161</sup> The term ‘airframe’ includes all attached parts and accessories, excluding the aircraft engine. This means that a fuselage, which is the central body of the aircraft accommodating the crew, passengers and cargo together with the wings, empennage (tail assembly) and the landing gear are, of course, included.<sup>162</sup> The smaller parts of these and other structures of the airframe should also be included as ‘accessories and parts’. Thus, landing gear may include wheels with shock absorbers, or skis for snow or floats for water. The wings of an aircraft also have a complex structure and include ailerons (movable flaps of the wings which control the aircraft’s rolling and banking movements) and other parts. Provided that these components can be installed on an airframe which conforms to other requirements of the Protocol, it would seem that all these parts should be included. So too, the data, manuals and records relating to the aircraft are treated as part of the definition of the airframe. Since these parts are constituent parts of the airframe, it is not possible to create and register an interest in the separate parts of the airframe and the interest of the creditor must relate to the airframe as a whole. However, the Protocol treats an aircraft engine, which is usually placed either underneath the wing of an aircraft or as an integral part of its fuselage, as a separate item which does not form part of the airframe.<sup>163</sup> For this reason, it is possible, for instance, to create and register an international interest in an aircraft engine even after it has been installed into the aircraft and not in the airframe itself.<sup>164</sup> This approach of the Protocol appears to be in line with the general perception of the aircraft engines in the industry as high value and easily

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<sup>160</sup> Art I(2)(e), the Aircraft Protocol.

<sup>161</sup> Goode, Commentary (n 4) 304.

<sup>162</sup> For the general information on the structure of an airframe, see: <<http://www.answers.com/airframe>>.

<sup>163</sup> L Clark, ‘The 2001 Cape Town Convention on International Interests in Mobile Equipment and Aircraft Equipment Protocol: Internationalising Asset-Based Financing Principles for the Acquisition of Aircraft and Engines’ (2004) 69 J Air L Com 3, 10.

<sup>164</sup> An interest in an aircraft engine cannot be affected by its installation on or removal from the aircraft. Article XIV(3), the Aircraft Protocol.

detachable items which are frequently leased or exchanged between various users of aircrafts.<sup>165</sup> By contrast, installed helicopter engines are not treated as separate objects or as aircraft objects at all and no international interest can be created or registered in relation to such an engine.<sup>166</sup> It is, however, possible to establish an international interest in a helicopter engine before it is installed into the helicopter or after it has been removed from it.<sup>167</sup> The rights created in the helicopter engine before its installation will be preserved during the period when it is installed into the helicopter.<sup>168</sup>

The Protocol defines ‘aircraft engines’ as aircraft engines (other than those used in military, customs or police services) powered by jet propulsion or turbine or piston technology and sets a minimum engine capacity in order to cut off lower value units from its scope.<sup>169</sup> Aircraft engines include all accessories and parts which are incorporated into it. This means that an international interest can, in principle, be created and registered in an aircraft engine including all such attachments.<sup>170</sup>

Finally, helicopters are defined as heavier-than-air machines which are not used in military, customs or police services and which are certified to transport i) at least 5 persons or ii) goods in excess of 450 kilograms.<sup>171</sup> As with the definition of aircrafts, the Protocol uses the carrying capacity of the helicopter to emphasise that only high value helicopters are covered by it.

Once it is established that an aircraft object is covered by the Convention and the Aircraft Protocol, the parties will have to describe this object for the purpose of Article 7 of the Convention. The description of the aircraft object must contain 3 elements, namely, the name of the manufacturer, the serial number allocated to the object by the manufacturer and its model designation.<sup>172</sup> Only

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<sup>165</sup> P Shupack, ‘On Boundaries and Definitions: A Commentary on Dean Baird’ (1994) 80 Virginia L Rev 2273, 2279, n 17; P Honnebier, ‘New Protocols and the Financing of Aircraft Engines’ (2006) 21 Air Space Law 15, 16.

<sup>166</sup> Goode, Commentary (n 4) 305.

<sup>167</sup> Ibid 108.

<sup>168</sup> Ibid 304.

<sup>169</sup> F Polk, ‘Cape Town and Aircraft Transaction in the United States’ (2006) 20 Air Space Lawyer 4.

<sup>170</sup> Goode, Commentary (n 4) 304.

<sup>171</sup> Art I(2)(l), the Aircraft Protocol.

<sup>172</sup> Art VII, the Aircraft Protocol.



when all three elements are indicated in the agreement for the international interest, will it be possible to create a valid international interest in this object.<sup>173</sup>

#### b) Railway objects

The Protocol defines railway rolling stock as ‘vehicles movable on a fixed railway track or directly on, above or below a guideway, together with traction systems, engines, brakes, axles, bogies, pantographs, accessories and other components, equipment and parts, in each case installed on or incorporated in the vehicles, and together with all data manuals and records relating thereto’.<sup>174</sup> The broad definition of the railway rolling stock includes, of course, conventional trains, such as locomotives, with no payload capacity of their own, and multiple units trains which can be used for passenger and freight transportation. But trams, mountain trains, maglev, metro trains and monorail trains are also included into the definition because they either hover above, move below or beside guideways.<sup>175</sup> At the same time, trolley buses and road trains (such as the ones used in Argentina, Australia and Mexico to move several trailers connected with one tractor unit) are not covered by the Luxembourg Protocol because they do not move on a fixed track.<sup>176</sup>

Since it is not always possible to differentiate between train systems which do cross borders and those which potentially can cross borders the drafters decided that both types of railway rolling stock should be included into the definition.<sup>177</sup> In contrast with the Aircraft Protocol, the Luxembourg Protocol does not consider engines as separate objects.<sup>178</sup> Locomotives, which can be considered as engines since they provide motive power to the train are not considered as such

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<sup>173</sup> Goode, Commentary (n 4) 316.

<sup>174</sup> Art I(e), the Luxembourg Protocol.

<sup>175</sup> R Castillo-Triana, ‘The Relevance of the Luxembourg Protocol for Central and South America’ (2007) *Unif L Rev* 46, 468.

<sup>176</sup> Goode (n 5) 288.

<sup>177</sup> However, Art 50(2) of the Convention allows a Contracting State to exclude application of the Convention to the type of railway rolling stock equipment which is used exclusively in an internal transaction. See H Rosen, ‘The Luxembourg Rail Protocol: a Major Advance in the Railway Industry’ (2007) *Unif L Rev* 427, 431.

<sup>178</sup> For this reason there is no separate definition of a train engine in the Luxembourg Protocol and engines are simply included into the definition of railway rolling stock. See Art I(e) of the Protocol.

for the purposes of the Protocol.<sup>179</sup> Consequently, it is possible to create and register an international interest in a locomotive separately from the train which it pulls. But other types of engines, such as the ones installed in a multiple unit train are not considered as separate railway objects and are treated as integral parts of the train carriage.<sup>180</sup> Finally, the definition of railway rolling stock also includes various accessories and parts of train equipment such as tracks, bogies and pantographs and all data and manuals relating to such equipment.

The Luxembourg Protocol prescribes that in order to identify a railway rolling stock object for the purpose of constitution of an international interest, the agreement relating to such an object must describe it either by a) item; b) by type or c) in a statement that the agreement covers all present and future railway rolling stock; or d) in a statement that the agreement covers all present and future rolling stock except for specified items or types.<sup>181</sup> An interest in future railway rolling stock identified in conformity with these requirements can be constituted as a valid international interest as soon as the chargor, conditional seller or lessor acquires the power to dispose of such object without the need for any new act of transfer.<sup>182</sup> The identification requirements of the Luxembourg Protocol differ from those prescribed by the Aircraft Protocol in that no unique identification of railway objects is required for the purposes of constitution of the international interest.<sup>183</sup> The main reason, why these two Protocols approach the issue of identification differently is the following. There are only a few big commercial manufacturers of the aircrafts which were able to develop a permanent and clear identification system of the aircraft objects.<sup>184</sup> In contrast, there are many railway rolling stock manufacturing companies worldwide and it is impracticable to search for a unique identifier of railway objects.<sup>185</sup> In addition, the identification numbers given to individual train wagons are not always permanent and can sometimes be painted on or wiped out from the wagon as required by the parties concerned.<sup>186</sup> For this reason, while the requirement of unique identification was

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<sup>179</sup> Goode (n 5) 288.

<sup>180</sup> Ibid 288.

<sup>181</sup> Article V(1), the Luxembourg Protocol.

<sup>182</sup> Article V(2), the Luxembourg Protocol.

<sup>183</sup> Rosen (n 177) 432.

<sup>184</sup> H Rosen, 'Creating an International Security Structure for Railway Rolling Stock: an Idea Ahead of its Time?' (1999) 2 Unif L Rev 313, 318.

<sup>185</sup> H Rosen, 'The Regimen of the Railway Rolling Stock Protocol' (2004) 1 ERPL 26, 33.

<sup>186</sup> Ibid 33.

not considered to be difficult to comply with under the Aircraft Protocol, a new approach to identifying railway objects was required under the Luxembourg Protocol.

The unique identification of the object under the Convention and the Protocols is primarily required for the purposes of asset-based registration.<sup>187</sup> Consequently, it was realised at the Luxembourg Diplomatic Conference that there is no need to require the unique identification of the railway object at the stage of constitution of the international interest which does not depend on its registration.<sup>188</sup> For this reason, the Luxembourg Protocol introduced two identification points: one, at the stage of constitution of the international interest and another, at the stage of registration of such interest in the International Registry.<sup>189</sup> While at the stage of constitution, it is possible to identify the railway object in general terms, such as, for instance, a long distance passenger train or a high speed train crossing English Channel, this will not be sufficient for the purposes of registration and some unique identifier of the object will have to be provided. In order to ensure the uniqueness of identification of the railway object so that it cannot vanish into thin air once the national identification number which was painted on it is wiped out at the conclusion of its sale, the Registrar under the Convention is required to provide such object with a unique identifier.<sup>190</sup> This unique identifier will have to be either a) affixed to the object; b) associated in the International Registry with the manufacturer's name and its identification number which is affixed on to the object or c) associated in the International Registry with a national or regional identification number affixed in the object.<sup>191</sup>

#### 2.4 The possibility of a floating charge

The flexible requirements of identifying the railway objects mean that the agreement for the international interest can describe such objects in very broad terms allowing the parties to such an agreement to create a floating security. Suppose that a debtor negotiates a loan for the purpose of the acquisition of new

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<sup>187</sup> Goode (n 5) 290.

<sup>188</sup> Ibid 290.

<sup>189</sup> Art V and Art XIV, the Luxembourg Protocol.

<sup>190</sup> Rosen (n 177) 432.

<sup>191</sup> Art XIV(1), the Luxembourg Protocol.

train wagons which are being manufactured in accordance with the debtor's specifications. The contract for the sale of the wagons may require the debtor to pay a substantial part of the purchase price before their manufacture is complete. For this reason, the loan would have to be extended before unique identification of the wagons can be accomplished. In addition, the parties to the loan agreement may anticipate that the debtor will need more funding for the acquisition of new railway tracks and locomotives in the future. The debtor may propose to repay the loan from the sale of some part of its existing fleet of multiple unit trains and to secure the repayment of the debt by its present and future railway objects. Since the funds for the repayment of the loan are anticipated to be generated from the sale of the existing railway equipment of the debtor, the parties may agree that the debtor should be free to sell its equipment without permission of the creditor in the ordinary course of business. In this case, the debtor will be able to conduct its business without seeking permission of the creditor in relation to each disposition of its assets and the secured creditor will have a valid security interest in the property of the debtor without the unnecessary administrative burdens associated with constant consultations with the debtor regarding its business decisions. Furthermore, once the debtor acquires new railway tracks and locomotives, these new objects will be automatically covered by the existing international security interest of the creditor without the need to enter into a fresh agreement.<sup>192</sup> The broad description of the collateral as 'present and future railway objects', the absence of the requirement of unique identification of each object and the contractual power of the debtor to dispose of the objects free from the security in the ordinary course of business would mean that the creditor's security interest will not be fixed in a particular asset of the debtor, but will 'hover' or 'float' over its present and future railway objects.<sup>193</sup> In the case of default, the creditor should be able to exercise its remedies in relation to available railway objects of the debtor. At the same time, it must be noted that while the requirements of Article V

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<sup>192</sup> Art V(2), the Luxembourg Protocol. But the interest in these new objects will still have to be registered in the International Registry.

<sup>193</sup> Similar to the English floating charge. See, for example, *Re Brightlife* [1987] Ch. 200; *Agnew v Commissioners of Inland Revenue* [2001] 2 A.C. 710; *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep. 142; See Beale, Bridge, Gullifer, Lomnicka (n 110) 102-156. For a distinction between fixed and floating charges see P Smart, 'Fixed or Floating? Siebe Gorman post-Brumark' (2004) Comp Law 331; D Capper, 'Fixed Charges over Book Debts-the Future After Brumark' (2003) Comp Law 325; K Baird and P Sidle, 'Spectrum Plus: House of Lords Decision – A Cloud With a Silver Lining?' (2005) Insolvency Intelligence 113.

of the Luxembourg Protocol allow the creation of a floating security interest, such a security will be of limited significance to the parties concerned. This follows from the rule of the Protocol that in order to register the international interest the parties have to provide a unique identification of each railway object.<sup>194</sup> Thus, if the security was granted in relation to ‘all locomotives and railway tracks which the debtor currently owns and will acquire in the future’, such a description of the collateral will not be sufficient for the purpose of registration of the international interest. The unregistered international interest retains its validity and will allow the secured creditor to exercise available remedies in the case of the debtor’s default. However, as the holder of an unregistered interest, the secured creditor will not be able to protect its priority status against the holders of registered interests and its position can be reduced to that of an unsecured creditor.<sup>195</sup>

The floating charge can generally be described as a security in a fund or a class of assets rather than in specific objects of which the fund is comprised.<sup>196</sup> A floating security allows the debtor to acquire new objects which are automatically covered by the existing security and to dispose of such assets free from the charge.<sup>197</sup> The main advantage of the floating security is that the debtor is left free to conduct business as it thinks fit and the secured creditor can rest assured that it has a present security interest in all such assets which are currently included in the fund.<sup>198</sup> When the debtor defaults or some other crystallising event occurs the floating security will crystallise into a fixed security and capture all such assets as may be found in the fund at this moment.<sup>199</sup> Only then will the issue of identification of particular assets become relevant as the secured creditor will need to know against which objects the security can be enforced. For this reason, unique identification of each object is not generally required at the stage of constitution of a floating security and it can be granted in ‘all present and future or after acquired property of the debtor’. Moreover, the requirement of unique identification of each object comprised in the fund of assets would defeat the main

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<sup>194</sup> Art XIV, the Luxembourg Protocol.

<sup>195</sup> This follows from Art 29(1) of the Convention stating that any registered interest has priority over an unregistered interest. At the same time, such a secured creditor may still be able to enforce its security interest under the applicable domestic law. See Goode (n 5) 31.

<sup>196</sup> *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch. 284, 295. Goode (n 7) 114.

<sup>197</sup> Beale, Bridge, Gullifer, Lomnicka (n 110) 105.

<sup>198</sup> *Ibid* 108.

<sup>199</sup> L Sealy and R Hooley, ‘Commercial Law: Text, Cases and Materials’, 3<sup>rd</sup> edn (Oxford, OUP 2005) 1079.

advantage of the floating security. The flexibility of the floating security, allowing the debtor to conduct business as if it were not encumbered at all while providing the secured creditor with a present security in the fund, would be lost if the debtor were required to specifically identify each new item added to and let out of the fund. Since the Aircraft Protocol requires aircraft objects to be uniquely identified at the stage of constitution of the international interest, it is not possible to create a floating security over such objects in the sense described above. In order to be able to grant a security in an aircraft object, the debtor will have to provide the creditor with the name of the manufacturer, the manufacturer's serial number, and the model designation of the object. This, of course, should be possible if, at the time when the loan is extended, the debtor knows which aircraft object it intends to purchase. But the situation may be different if, for instance, the debtor has not yet placed an order with the manufacturer. In this case, the debtor may know the name of the manufacturer and the model designation which it would like to purchase, but not the serial number which will only be allocated to the object once the contract with the manufacturer is entered into.<sup>200</sup> So too, a debtor planning to renew its fleet of aircrafts over the period of three years, may seek a loan for the prospective purchases at the same time as it negotiates the acquisitions with several sellers. At the time when the loan will have to be provided the debtor may not have advanced far enough in its acquisition negotiations in order to allocate particular aircraft objects to the security agreement. As a result, the debtor will not be able to uniquely identify each aircraft object for the purpose of the constitution of the security interest in favour of the creditor. Therefore, the requirement of unique identification of the aircraft objects precludes the conventional floating security from coming into existence. In these circumstances a fixed security may prove to be more practical.<sup>201</sup> It follows that the international interest can be taken only in relation to present and not future aircraft objects and each such objects must be uniquely identified in the agreement for the international interest. So, if at the stage of constitution of the international interest, the debtor cannot provide the creditor with description of all aircraft objects which it intends to buy in the

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<sup>200</sup> A serial number is usually allocated to an aircraft at the stage when the contract for its acquisition concluded between the manufacturer and the purchaser is entered into. See: <[http://en.wikipedia.org/wiki/United\\_Kingdom\\_military\\_aircraft\\_serials](http://en.wikipedia.org/wiki/United_Kingdom_military_aircraft_serials)>.

<sup>201</sup> For a distinction between fixed and floating charges in the context of English law see A McKnight, 'Brumark: the Difference Between Fixed and Floating Charges' (2001) JIBL 157; C Davis, 'Floating Rights' (2002) CLJ 423; Sealy and Hooley (n 199) 1079.

following three years, the parties will have to enter into a fresh agreement each time a new aircraft object can be identified in conformity with the Protocol.

As was noted above, a floating charge is a security in a fund of assets. The assets of the debtor can flow in and out of this fund until the charge crystallises or attaches to whatever assets can be found in this fund at that moment. But there appears to be no need for a fund to be open-ended.<sup>202</sup> Romer L.J. has described the floating charge in the following terms:

‘I certainly do not intend to attempt to give an exact definition of the term ‘floating charge’...but I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge. (1) If it is a charge on a class of assets of a company present and future; (2) If that class is one which in the ordinary course of the business of the company would be changing from time to time; and (3) If you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets I am dealing with.’<sup>203</sup>

The later English cases revealed that the words of Romer L.J. were not in the form of the definition, but in the form of the description of what may amount to a floating charge. While the first two features are typical of a floating charge, it is the third feature (freedom to deal with the assets in the ordinary course of business) which is distinctive of the floating charge.<sup>204</sup> It follows that as long as the debtor has the power to deal with the assets in the fund, the security in such a fund can be a floating security even if the fund is restricted to present and does not include any future assets.<sup>205</sup> Viewed from this angle, this may mean that as long as the security is restricted to the present assets of the debtor which can be uniquely identified and provided that the debtor has the power to deal with them in the ordinary course of business, a floating security in aircraft objects can be taken under the Aircraft Protocol. Thus, the debtor in need of a loan for the purpose of acquiring new airframes and aircraft engines may not immediately know the unique descriptions of these future assets. So no security or other international

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<sup>202</sup> Gullifer (n 7) 4-04.

<sup>203</sup> *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch. 284, 295.

<sup>204</sup> *In re Bond Worth Ltd* [1979] 3 All E.R. 919; Beale, Bridge, Gullifer, Lomnicka (n 110) 133.

<sup>205</sup> Gullifer (n 7) 4-04.

interest can arise in these objects.<sup>206</sup> However, the parties may agree that the loan will be secured by the existing aircraft objects of the debtor. The parties may also agree that the loan will be mainly repaid from the sale of such existing aircraft objects and that the debtor will be free to dispose of them in the ordinary course of business. Since the debtor will be able to identify all such existing objects in conformity with the Aircraft Protocol, and will still have the power to dispose of them, a floating security over the fund of such existing objects can, in principle, be taken by the secured creditor. Moreover, because the requirements of identification of the aircraft objects are the same for the purposes of constitution and registration of the international interest, the holder of the floating security in the fund of existing aircraft objects of the debtor can register and secure its priority among other holders of international interests. It follows that in the case of the debtor's default, the holder of the floating security can enforce its security to the exclusion of all subsequently registered and unregistered holders of other interests in the same aircraft objects of the debtor.

To summarise, it is suggested that a floating security can, in principle, be taken both under the Luxembourg and the Aircraft Protocols of the Convention. In relation to railway objects, the flexible identification requirements of Article V suggest that the collateral can be broadly described by type, or item or relate to present and future objects. This means that a floating security over 'all present and future railway objects of the debtor' can be created under the Luxembourg Protocol. However, the stricter identification requirements for the purpose of registration mean that a validly created floating security in railway objects cannot be registered in the International Registry and the creditor cannot secure its priority position in relation to other holders of registered international interests. The Aircraft Protocol requires unique identification of aircraft objects both at the stages of constitution and registration of the international interest. It follows that no international interest, including a floating security, can be taken in future unidentified assets of the debtor. However, if the floating security is viewed as a security over a fund of existing uniquely identifiable assets of the debtor and the debtor is given the power to deal with such assets in the ordinary course of

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<sup>206</sup> Even a prospective interest cannot be registered at this stage because identification requirements will still have to be met. See Goode (n 5) 22.



business, than it may be possible to create and register the floating security in such assets.

## 2.5 *'Identification of secured obligations'*

The final formal requirement of Article 7 is only relevant when the international interest is based on the security agreement. In this case, the security agreement must enable the secured obligations to be determined, but without the need to state a sum or a maximum sum secured.<sup>207</sup> The security agreement can secure performance of existing as well as future obligations.<sup>208</sup> Thus, a debtor may agree to grant a security interest to the secured creditor after the loan has been provided.<sup>209</sup> In this case, the purpose of the security agreement will be to secure the repayment of this existing debt to the secured creditor. But the definition of the security agreement under the Convention means that it can be entered into for the purpose of securing future obligations of the debtor and a third party.<sup>210</sup> So, the debtor who is offered an opportunity to use a revolving credit facility limited to a certain maximum sum, may borrow as much funds as may be required within that amount and whenever needed for its purposes. At the time of conclusion of the security agreement the parties will not necessarily know when and how much will be borrowed by the debtor. The security interest will then be needed to secure

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<sup>207</sup> Art 7(d), the Convention. This approach of the Convention is different to the position of some legal systems where the security agreement must indicate the exact or the maximum amount of the secured obligation in order to be valid. While the security agreement may, in principle, state the amount of the secured debt as required by such legal systems, this is not a validity requirement under the Convention. It follows that even if a security agreement lacking this information would have been invalid under certain applicable domestic law, it will still be valid under the Convention. For the examples of those legal systems where the information regarding the exact or maximum sum secured must be indicated in a valid security agreement see B Bennet, 'Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns' (1999) 77 Tex L Rev 1443, 1450; T Rodrigues, 'International Regulation of Interests in Aircraft: the Brazilian Reality and the UNIDROIT Proposal' (2000) 65 J Air L Com 279, 291; F Dahan and G McCormack, 'International Influences and the Polish Law on Secured Transactions: Harmonisation, Unification or What?' (2002) 7 Unif L Rev 713, 723; T Josipovic, 'The Rail Protocol and Croatian Secured Transactions Law' (2007) Unif L Rev 489, 496-497; H Gutierrez-Machado, 'The Personal Property Secured Financing System in Venezuela: A Comparative Study and the Case for Harmonisation' (1998) 30 U Miami Inter-American L Rev 343, 354-355.

<sup>208</sup> Ali (n 10) 70.

<sup>209</sup> Gullifer (n 7) 2-08.

<sup>210</sup> Art 1(ii), the Convention. The position is different under English law where until the loan is provided the secured creditor will only have an inchoate security in the collateral. Once the loan is advanced to the debtor, the security interest will attach to the collateral. See Gullifer (n 7) 2-08.

the repayment of all such future indebtedness which may be incurred by the debtor.

Although performance of both existing and future obligations can be secured, there is no need to specify the exact or maximum amount of the secured debt. It will be sufficient to describe in general terms the nature of the secured obligations. For instance, an agreement securing the repayment of 'all sums due from the debtor to the secured creditor now or in the future' will be sufficient for the purposes of the Convention.<sup>211</sup> To require the parties to indicate the exact or maximum amount of the secured obligation would be impracticable for two reasons. First, if the amount of future indebtedness is not certain at the time of the conclusion of the security agreement, the creditor may simply state a sum which will be in excess of what may be required by the debtor.<sup>212</sup> Secondly, even if the exact amount of the secured debt is indicated in the security agreement, it does not state how much of this debt has already been repaid at any relevant time.<sup>213</sup> So any potential secured creditor willing to take a security interest in the same asset of the debtor will not be able to determine exactly how much the debtor still owes to the previous secured creditor. To obtain this information, the potential secured creditor will need to ask the parties to the security agreement for further details. Consequently, the indication of the exact or maximum amount of the secured obligation would have little informative value to any third party.<sup>214</sup>

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<sup>211</sup> Goode, Commentary (n 4) 177.

<sup>212</sup> Ibid 177.

<sup>213</sup> Ibid 177.

<sup>214</sup> Ibid 177.

## Chapter III: Registration of International Interests in Mobile Equipment

### 1. General

Before extending a loan to a debtor, a creditor will need to know whether the object offered to it as collateral is already subjected to a prior security or other international interest. This information may help the creditor assess risks associated with the repayment of the debt. If the object is subject to another security, the creditor may realise that, in the case of the debtor's insolvency, it may not have immediate access to the object and will have to wait for the prior secured creditor to satisfy its claim first. By the time the creditor gains access to whatever is left of the collateral, there may not be enough to cover the repayment of the debt. Once the creditor obtains the information in relation to prior interests, it may decide not to lend at all, or to include the risks in the cost of the credit, or to enter into a subordination agreement with the prior creditor.<sup>1</sup> On the other hand, if the creditor is the first to be granted a security in the object held by the debtor, it may be more certain that in the case of the debtor's default it will be able to sell the collateral and apply the proceeds for the repayment of the debt.

Once the loan is provided, the secured creditor will need to ensure that any subsequent creditors of the debtor are aware of the existence of its security interest. This will be particularly important if the debtor (as is often the case) retains possession of the object and uses it in the course of its business. Since the existence of the security will not usually be apparent from the visual examination of the object, subsequent secured and unsecured creditors may be induced to believe that it is not subjected to any prior interest. As a result, secured creditors may act on the understanding that they will be the first creditors to be granted security interests in the collateral. Unsecured creditors may also be confused by the debtor's appearance of wealth and assume that the pool of assets available for distribution to them is larger than it actually is.<sup>2</sup>

One way to learn whether the object is subject to any prior claims and to notify subsequent creditors about the existence of the security, is to ask the debtor

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<sup>1</sup> S Harris, 'The International Rail Registry' (2007) *Unif L Rev* 531, 536.

<sup>2</sup> This situation, which is also known as the false wealth problem, may be cured by publicising interests in a public register. See P Wood, *Comparative Law of Security Interests and Title Finance*, 2<sup>nd</sup> edn (London, Sweet & Maxwell 2007) 141-142.

to provide the information regarding the former and to let prospective creditors know about the security interest of the creditor.<sup>3</sup> In this case, the creditor will have to rely on the debtor to reveal any previous claims to the collateral and monitor whether the debtor obtained any subsequent loans and gave notice to its other creditors about the existence of the security interest in the future.<sup>4</sup> While some jurisdictions find this approach acceptable, it may be both naïve to expect the debtor to fully disclose information regarding its prior creditors (as it may prejudice the availability and cost of credit) and inefficient for the secured creditor to constantly monitor the debtor.<sup>5</sup> Another way to achieve these objectives is to take possession of the collateral.<sup>6</sup> This should put subsequent creditors on notice that since the debtor cannot use the object as its own, it may be subjected to some prior security interest.<sup>7</sup> However, this approach may prove to be commercially impractical as the secured creditor may find it prohibitively expensive to store the collateral and the debtor will usually need the object in order to generate funds for the repayment of the debt. Furthermore, delivery of possession merely shifts the problem from the debtor to the creditor: once the latter obtains possession, it may appear to its own creditors as the owner of the object.

In contrast, registration of proprietary interests in a registry may offer a more effective solution. By searching the register, the creditor may ascertain whether the object is already encumbered by a prior interest. Similarly, by

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<sup>3</sup> For example, under German law where there is no public register of security interests in movable objects, creditors have to rely on debtor's representations and conduct their own investigations in order to reveal whether the collateral is encumbered by any proprietary interests. German law attempts to deal with the problem of secret liens by providing that the pledge, requiring delivery of possession of the object to the creditor, is the only statutory form of security interest. Due to its impracticality, pledge is not used very often in commercial transactions, which led to the development of other forms of security interests in practice. See J Hausmann, 'The Value of Public Notice Filing under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property' (1996) 25 Georgia J Int'l Comp L 427, 452-454.

<sup>4</sup> This is the position under Russian law where a public register for security interests in movable property does not exist. See B Bennett, 'Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns' (1999) 77 Tex L Rev 1443, 1452.

<sup>5</sup> Bennett (n 4) 1455-56.

<sup>6</sup> Possessory pledges are not usually registrable because the owner's dispossession of the object is considered to be sufficient for the purposes of publicity. See A Greco, 'National Report on the Transfer of Movables in Italy' in W Faber and B Lurger (eds), *National Reports on the Transfer of Movables in Europe, Volume I: Austria, Estonia, Italy, Slovenia* (Sellier, European Law Publishers 2008) 364.

<sup>7</sup> E Adams, S Nickles, S Sande, W Shiefelbein, 'A Revised Filing System: Recommendations and Innovations' (1995) Minn L Rev 877, 883. This is also the position under French law where no public register at which pledges over tangible personal property can be registered exists and physical delivery of the object is both necessary and sufficient to perfect the pledge. See M Gdanski, 'Taking Security in France' in M Bridge and R Stevens (eds), *Cross-Border Security and Insolvency* (Oxford, OUP 2001) 65.

registering the security interest, the secured creditor may ensure that subsequent creditors will discover its existence if they search the registry before granting a loan to the debtor. This is precisely what the International Registry established under the Convention and its Protocols aims to achieve.<sup>8</sup> It allows the creditor to learn about the possible existence of prior interests in the collateral and to give notice about its own interest in it to other potential creditors of the debtor.

In the case of debtor's insolvency, the mere knowledge of the possible existence of other proprietary interests in the object may not be sufficient: the secured creditor will need to know whether its security can be immediately enforced or should be postponed to a prior international interest. To settle this matter, the Convention puts registration of international interests at the centre of its priority scheme. By establishing that a registered interest has priority over any other interest subsequently registered and over an unregistered interest,<sup>9</sup> the Convention allows the creditor to secure its priority status amongst other creditors of the debtor. Finally, registration of the international interest in the International Registry allows its holder to preserve its effectiveness during the debtor's insolvency, provided that such registration was effected prior to the commencement of the insolvency proceedings.<sup>10</sup>

The main objective of the international registration system under the Convention and its Protocols is to make asset-based financing of high value mobile equipment more transparent which may help reduce risks and the cost of credit. This can be achieved by making the register a reliable source of information about various interests held in such objects and by determining priorities among competing interests by the order of registration. This Chapter will examine the defining features of the International Registry, its administrative structure and the process of registration in an attempt to assess whether these objectives were met.

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<sup>8</sup> For a general overview of the reports of the International Registry Task Force see J Standell, 'The Role of the International Registry Task Force (I.R.T.F.) in the Development of the International Registry for Interests in Aircraft' (2006) *Unif L Rev* 8.

<sup>9</sup> Art 29, the Convention.

<sup>10</sup> Art 30(1), the Convention. Other registration systems may serve different purposes. For example, registration of motor vehicles may be required for fiscal purposes, such as payment of tax or in order to detect and prevent road traffic offences as well as to establish who is responsible for the vehicle. See I Davies, 'Registration Documents and Certification of Title of Motor Vehicles' (2001) *JBL* 489, 496.

## 2. The International Registry

### 2.1 Regulations and Procedures

The operation and use of the International Registry are governed by the Convention, relevant Protocols as well as Regulations and Procedures issued pursuant to such Protocols.<sup>11</sup> The Convention is merely a frame document, which is supported by equipment-specific Protocols. The controlling power of the Protocol is evident from its treatment by the Convention: both should be read and interpreted together as a single document and in the case of any inconsistency between them, the Protocol should prevail.<sup>12</sup> The same does not apply to the Regulations and Procedures which must comply with Protocols and the Convention.<sup>13</sup>

The fact that the International Registry is governed by four different documents may seem unnecessarily complex. Indeed, even the question whether there should be a distinct Convention and several equipment-based Protocols was subject to a heated debate at the Diplomatic Conference.<sup>14</sup> The question which may arise in this respect is whether the additional layer of Regulations and Procedures was necessary and why the issues governed by these documents could not have been incorporated into the relevant Protocols? The answer to this question may lie in extremely technical nature of the issues covered by the Regulations and Procedures. These documents are essential to the operation and use of the International Registry in that they provide how the registrations can be effected, amended, searched for and discharged and who may be eligible to do so. The Protocols would be too technical and cumbersome if these issues were incorporated into their texts. Another reason why separate Regulations and

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<sup>11</sup> R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*, Revised edn, (UNIDROIT, Rome 2008) 49.

<sup>12</sup> Art 6.

<sup>13</sup> The first Regulations were issued by the Supervisory Authority pursuant to Art 17(d) of the Convention and Art XVIII of the Aircraft Protocol and are now in their 3d Edition.

<sup>14</sup> R Goode, 'The Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment' (1999) 4 *Unif L Rev* 265, 269-271; C Chinkin and C Kessedjian, 'The Legal Relationship between the Proposed UNIDROIT Convention and its Equipment-Specific Protocols' UNIDROIT Document Study LXXII-Doc 47 and ICAO Ref LSC/MEE-WP/12, reproduced (1999) 4 *Unif L Rev* 323, 323-325.

Procedures were considered to be necessary may have been the desire of the drafters of the Convention to enable the International Registry to be up to date with technologic developments and other changes. For instance, should the name of the Registrar or the URL of the International Registry change, it would be more expedient to issue a new edition of the Regulations and Procedures rather than to seek approval of Contracting States in order to make relevant changes in the Protocols. The only possible drawback of this solution may be that certain issues are repeated in the Convention, Protocols, Regulations and Procedures. For instance, the fact that the International Registry is electronically operated and accessible 24 hours 7 days a week subject to maintenance periods is repeated in all documents. But, as long as there is no contradiction between them, this should not present a major problem.

The main purposes of the Regulations and Procedures are twofold. First, these documents provide detailed practical rules for the operation and use of the International Registry. While the general structure of the registry, interests which can be registered and the process of effecting, searching and discharging a registration are governed by the Convention and the Protocol, more detailed issues, such as access to the International Registry, and information required to effect and search a registration are covered by the Regulations. For instance, the Convention indicates that there should be some criteria for unique identification of objects for the purposes of effecting and searching registrations, but states that they should be specified by Protocols and Regulations.<sup>15</sup> The Regulations provide a list of detailed criteria which must be met in order to effect a registration.<sup>16</sup> These formal requirements are tailored to a particular type of interest which can be registered in the registry. Consequently, they may differ depending on the type of interest and may include such requirements which are not specifically mentioned in the Convention or the Protocol. For example, to effect a registration, a registering party should (amongst other requirements) indicate its identity, which must be supported by an electronic signature.<sup>17</sup> While the definition of writing in the Convention is sufficiently broad to cover the use of electronic documents or 'records', it does not specify that these records must be signed.

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<sup>15</sup> Art 18(1).

<sup>16</sup> Sec 5.

<sup>17</sup> Sec 5.3(a).

Such records must ‘indicate by reasonable means the person’s approval of the record’,<sup>18</sup> which may include an electronic or a manual signature. Since the International Registry is an electronically operated system, the use of a manual signature may prove to be inefficient. For this reason, the Regulations stipulate for a more specific, although not expressly mentioned in the Convention, requirement of electronic signature in relation to registrations in the registry. Similarly, the Aircraft Protocol provides that the search criteria for an aircraft object should be the name of its manufacturer, manufacturer’s serial number and its model designation.<sup>19</sup> These requirements can be supplemented by the Regulations to ensure uniqueness of the objects.<sup>20</sup> The Regulations, in turn, specify that, in relation to an airframe or a helicopter, searches may additionally be performed against the State of Registry of the aircraft of which the airframe is a part or the nationality or registration mark of such object.<sup>21</sup> The Regulations also provide that a Supervisory Authority may issue Procedures relating to administrative processes of the International Registry.<sup>22</sup> The Procedures cover such issues as functions of the administrator and registry users as well as ways to access the help desk, should technical support in relation to the International Registry be required.

Secondly, the Regulations and Procedures establish an elaborate system of authorisations, approvals and consents, along with such new definitions as an administrator and registry user entity in order to ensure the security and integrity of the International Registry. Once the meaning of these terms is understood, it becomes clear that although the International Registry is an electronically operated system which can be accessed from any computer with an Internet connection, not everyone can register an interest in it. A creditor providing a loan to an airline on security of an aircraft operated by it cannot simply register its interest in this object in the International Registry. The creditor, i.e. a person intending to be a party in one or more registrations, may be defined by the Regulations as a transacting user entity<sup>23</sup> and a law firm (or the creditor’s internal legal department), providing professional services in connection with such

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<sup>18</sup> Art 1(nn).

<sup>19</sup> Art XX(1).

<sup>20</sup> Art XX(1).

<sup>21</sup> Sec 7.1(d),(e).

<sup>22</sup> Sec 15.

<sup>23</sup> Sec 2.1.12. An individual employee of such entity may be called a transactional user.



registrations, will be defined as a professional user entity.<sup>24</sup> Together, they may be called a registry user entity.<sup>25</sup> None of these parties can simply register an interest in the International Registry unless they receive an electronic authorisation issued by their administrator. The administrator is the person who has authority to act on behalf of the registry user entity (the creditor or its legal team) on administrative matters in dealing with the International Registry.<sup>26</sup> So, it is the administrator who, in practice, can effect, amend or discharge registrations<sup>27</sup> and each registry user entity can only have one administrator at any given time.<sup>28</sup> Apart from the administrator, registrations can also be effected, amended or discharged by a registry user (an employee of the creditor or its legal team), but only if such registry user has been approved by the administrator.<sup>29</sup> Even if the approval is granted, the registry user will have to seek further electronic authorisation from the administrator before transmitting any information to the International Registry.<sup>30</sup> Both the administrator and the approved registry user must have a unique digital certificate on their computers which should not be transferred to anyone else.<sup>31</sup> The sophisticated security system of the International Registry provided by the Regulations and Procedures may mean that the creditor extending a loan to the debtor will have to make some prior arrangements and find a suitable administrator in order to be able to register its security interest in the aircraft. But once all these arrangements are put in place, the same administrator can be used for any future dealings with other debtors of the creditor which may be a relatively small price to pay to ensure the security of the International Registry.

The need to obtain necessary authorisations and to make prior arrangements with the registry may not be the only preconditions which must be satisfied by a registering party before a registration of its interest can be effected. The Convention empowers Contracting States to designate an entity or entities in its

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<sup>24</sup> Sec 2.1.8. An individual employee, member or partner of such entity may be called a professional user.

<sup>25</sup> Sec 2.1.10. A transactional user or a professional user may be called a registry user.

<sup>26</sup> Sec 2.1.1 of the Regulations. The administrator can delegate its functions to an acting administrator. See sec. 5.6 of the Procedures.

<sup>27</sup> Sec 5.4 of the Procedures. The administrator must first be approved by the Registrar which is another control mechanism designed to ensure security of the International Registry.

<sup>28</sup> Sec 5.3 of the Procedures.

<sup>29</sup> Sec . 6.1 of the Procedures.

<sup>30</sup> Sec 6.2 of the Procedures.

<sup>31</sup> Sec 5.7. and Sec 6.3 of the Procedures.

territory to serve as entry points.<sup>32</sup> The Regulations specify that the purpose of these entry points is either to authorise transmission of the registration information<sup>33</sup> or to directly transfer submitted data to the Registrar.<sup>34</sup> Where a Contracting State has designated an entry point, the registering party will not be able to register its interest directly in the International Registry and will have to submit the registration information to the entry point first.<sup>35</sup> The registration information will then be either directly sent to the International Registry or authorised to be sent there by the registering party. It is also open to the Contracting State to set additional requirements which must be satisfied by the registering party before the registration information can be transmitted to the International Registry.<sup>36</sup> Such requirements may differ from those required under the Convention and the Regulations and may include additional fee, signature of both the creditor and the debtor, a copy of the security agreement giving rise to the international interest or a proof of title of the conditional seller or lessor.<sup>37</sup> In relation to aircraft objects, the Regulations preclude the use of entry points with respect to registration of interests in aircraft engines.<sup>38</sup> In addition, entry points cannot be used for the purpose of registration of notices of national interests and registrable non-consensual rights and interests arising under the law of another State.<sup>39</sup>

The use of entry points can further support the security system of the International Registry by ensuring that inappropriate, mistaken or bogus registrations are not made in it. The entry points may be used as additional filter checking that the information which is about to be submitted to the International Registry is correct and reflects the agreement between the parties. Contracting States may also wish to use entry points for other purposes, such as collection of

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<sup>32</sup> Art 18(5).

<sup>33</sup> Such entry points are denominated as authorising entry points by Sec 12.1(a) of the Regulations.

<sup>34</sup> These entry points are referred to by Sec 12.1(b) of the Regulations as direct entry points.

<sup>35</sup> Sec 12.5 of the Regulations.

<sup>36</sup> Art 18(5).

<sup>37</sup> R Cuming, 'The International Registry: An Overview of its Structure' (2006) *Unif L Rev* 18, 34-36.

<sup>38</sup> The reason for this is mainly historic. While almost all States now have recording offices operated by civil aviation authorities at which aircrafts and helicopters can be registered as to nationality, such offices do not usually distinguish between airframes and engines. It was envisaged by the drafters of the Convention that Contracting States would use existing offices as entry points. Since these offices do not usually distinguish between airframes and engines, there was no need to require that interests in engines should be approved by entry points. See Cuming (n 37) 34-36.

<sup>39</sup> Art XIX(1), the Aircraft Protocol.

stamp duty, tax or to gather statistical data. Since the drafters of the Convention envisaged that Contracting States will use existing agencies of civil aviation authorities for this purpose, this may mean that the expense of establishing the entry points would not necessarily be great. Furthermore, the designation of entry points is not mandatory and it is for the Contracting States to decide whether such entities are needed at all.<sup>40</sup> On the other hand, it is suggested that even the option to set such entry points given to the Contracting States may be questionable from the perspective of the International Registry users. It may be argued that since the Regulations already provide for a sophisticated system of control mechanisms, the additional check at the entry point adds little to the security of the registry. Moreover, the authorisation to transfer the data to the International Registry may be turned down at the entry point even if all the formalities prescribed by the Regulations have been met. This may happen if one of the additional requirements of the entry point was not complied with and, for example, an incorrect application form was used by the registering party. This may delay the registration of the international interest in the International Registry which may affect the creditor's priority status. Even if the authorisation process at the entry point does not involve any problems, it may still delay the registration of the international interest. The creditor will have to spend some time investigating whether a relevant Contracting State has established an entry point and, if so, what formal requirements must be complied with. The creditor may have to physically deliver the necessary documents and to bear in mind that entry points need not be operational 24 hours a day 7 days a week, which may also slow the process of authorisation.<sup>41</sup> Finally, there may be a gap between the time when the information is submitted to the entry point and the time when the necessary authorisation from it is received by the registering party. Since the Convention does not prescribe that the entry points should act within a specified period, the process of checking the information and issuing the authorisation can take anything from two days to a week. During this time, the registering party may be ready to effect a registration in the International Registry, but unable to do so because of the delay at the entry point. Even in the case of a direct entry point, the

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<sup>40</sup> As of January 2010, only Albania, China, Mexico, United Arab Emirates and the United States of America declared that entry points should be established on their territories.

<sup>41</sup> Entry points only have to be operational during working hours in their respective territories. Art XX(4) of Aircraft Protocol.

registering party will have to wait until the information is actually transferred to the International Registry and becomes searchable in it. Until this moment, the registration will not be effective and the registering party will not be able to ascertain or secure its priority among other creditors.<sup>42</sup>

## 2.2 Defining features of the International Registry

### 2.2.1 Electronic International Registry

The International Registry is a fully electronic Internet-based system which can be accessed for the purposes of effecting and searching a registration from any part of the world.<sup>43</sup> It operates 24 hours a day, 7 days a week, but access to it may be precluded by necessary maintenance works which should be performed outside peak periods.<sup>44</sup> The Convention envisages that different international registries may be established to record and search interests held in various categories of objects governed by it.<sup>45</sup> At present, only the International Registry for aircraft objects is in operation.<sup>46</sup> The Registry was established and is operated by Aviareto<sup>47</sup> and is based in Dublin, Ireland.<sup>48</sup>

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<sup>42</sup> The designation of entry points is limited to registrations. In contrast, searches need not be conducted through entry points and may be effected from any computer of the searching party's choice. See Goode (n 11) 203.

<sup>43</sup> In contrast, some jurisdictions require physical delivery of necessary documents to the Registry in order to effect a registration. See J Wilson, 'Movable Equipment Financing in Latin America: Application of the OAS Model Law, the Cape Town Convention and the Luxembourg Rail Protocol' (2007) *Unif L Rev* 473, 485.

<sup>44</sup> Sec 3.4, the Regulations.

<sup>45</sup> Art 16(2). See B Honnebier, 'The Fully-Computerised International Registry for Security Interests in Aircraft and Aircraft Protocol that will Become Effective Toward the Beginning of 2006' (2005) *J Air L Comm* 63, 71.

<sup>46</sup> The International Registry can be accessed at: <<https://www.internationalregistry.aero/irWeb/pageflows/work/UserManagement/MaintainProtectedPages/handleMissingCertificate.do>>. The International Registry is actively used. For example, in 2007, 12,086 registration sessions and 49,920 search sessions from the US alone were performed. See Second Annual Statistical Report available at: <<https://www.internationalregistry.aero/irWeb/pageflows/work/Reports/DownloadAnnualReport/DownloadAnnualReportController.jspf>>.

<sup>47</sup> Aviareto is a joint venture company of SITA (an air transport telecommunications and IT solutions company, which was created and owned by air transport community) and the Irish Government. More information on Aviareto can be found at: <<http://www.aviareto.aero/>>.

<sup>48</sup> International Registries for railway and space objects are in the process of development. It is expected that they will follow the approach taken by the International Registry of Aircraft objects as much as possible. At the same time, such registries will have to reflect features which are specific to the Luxembourg and Space Protocols. R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock* (Rome, UNIROIT 2008) 112.

The most obvious and significant advantage flowing from the fact that there is only one electronic Aircraft International Registry is that location of the collateral, debtor or the creditor becomes irrelevant for the purposes of effecting a registration or making a search. Provided that the registering or searching party has access to an Internet connection, it can, in principle, record its interest in the aircraft object from any place in the world.<sup>49</sup> The elegance of this simple approach can perhaps be better appreciated when compared with some other registration systems. The existing multiple filing offices established under the US Uniform Commercial Code can illustrate the point. Although most UCC filing offices are electronically operated and can, in principle, be accessed from any location, there is no nationwide registry and each state may have a central filing office in which security interests in most types of collateral can be recorded and county filing offices where specified security interests should be recorded.<sup>50</sup> The registration or filing of a security interest in the correct office may have significant importance to the secured creditor since security interests which are not correctly filed or perfected are subordinated to a subsequent holder of a perfected security interest. Since there were more than 4200 separately operated UCC filing offices at any one time, ensuring that the security interest was recorded in the correct office and that it could be found by subsequent creditors might be difficult.<sup>51</sup> Section 9-301(1) of the Revised Article 9 introduced an important change designed to simplify the process of filing in that for most types of collateral, security interests must be filed in a central filing office where the debtor is located.<sup>52</sup> But the

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<sup>49</sup> Although the International Registry can be accessed from any place in the world, the Convention will only apply if the debtor was situated in a Contracting State at the time of the conclusion of the agreement creating or providing for the international interest. See Art 3, 4 of the Convention.

<sup>50</sup> By way of exception, financing statements with respect to 'as extracted collateral', 'timber to be cut' and 'fixture filings' in relation to goods which are or are to become fixtures, should be filed in offices for mortgages on real property to which such collateral relates. See Hon. J Pearson, 'Revised Article 9 in Kansas' (2003) 51 U Kan L Rev 796, 832.

<sup>51</sup> L LoPucki, 'Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway' (1992) 55 Law Contemporary Problems 5, 16.

<sup>52</sup> Uniform Commercial Code: Official Text and Comments, 2009-2010 edn (Thomson West 2009) 896. This approach brings a welcome change since the rule under the former Article 9 UCC was more complex. Generally, security interest in intangible collateral had to be filed in the state where the debtor was located, whereas security interest in tangible collateral had to be filed in the state where such collateral was located. This meant that once the tangible collateral was moved to a different state, the financing statement had to be re-filed in the new location. In addition, if tangible collateral held by the debtor was situated in different states, financing statement covering such collateral had to be filed in several states and the secured creditor had to monitor whether its location had changed. Not only did this approach bring practical difficulties to the secured creditor, but it was impractical for a searcher too since it had to check several filing offices in

secured creditor will still need to ascertain the proper location of the debtor which may depend on whether the debtor is an individual, has one or several places of business or whether it is a registered organisation.<sup>53</sup> Once the security interest is properly filed, the secured creditor may have to monitor whether the debtor has changed its location. Should this happen, the secured creditor will have a grace period (four months or one year, depending on the circumstances) during which it can re-file its financing statement in the state of the new location of the debtor.<sup>54</sup> A failure to do so may cause the loss of priority to a subsequent secured creditor who obtained its interest after the change.<sup>55</sup> Despite the new rules of the Revised Article 9, the filing and search of financing statements can still be a complex process and many creditors rely on services of private search firms in order to find out whether the object offered to them as collateral is already encumbered by a prior interest.<sup>56</sup> The multiplicity of filing offices and uncertainty in relation to proper location led to suggestions that a single electronic nationwide registry incorporating all existing filing offices could provide a more efficient way of effecting and searching financing statements.<sup>57</sup>

Since the International Registry is a fully electronic system, the registration data can only be transmitted to the Registry in electronic format and hard copy cannot be sent to the Registrar.<sup>58</sup> This approach may be contrasted with other systems whereby the registering data is submitted in hard copy and either stored as such or entered manually or electronically to an electronic database by the

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order to establish whether the collateral was encumbered. See C Cheatham, 'Changes in Filing Procedures Under Revised Article 9' (2000) *Oklahoma City U L Rev* 235, 240; R Ihne, 'Revised Article 9 – A Practical Guide to Perfecting and Maintaining Perfection of Security Interests in Basic Equipment and Chattel Paper Financing' (2001) *American Bar Association Continuing Legal Education*; R Anzivino, 'State Bar Urges Adoption of UCC Revised Article 9' (2001) *Wisconsin Law* 22.

<sup>53</sup> Article 9-307 UCC.

<sup>54</sup> S. 9-316(a) Article 9 UCC. For the purposes of grace period and explanation how this period operates see *Uniform Commercial Code: Official Text and Comments* (n 52) 931. See also H Sigman, 'The Filing System under Revised Article 9' (1999) 73 *Am Bankr L J* 61, 65-66.

<sup>55</sup> Sigman (n 54) 66.

<sup>56</sup> J Eikenburg, 'Filing Provisions of Revised Article 9' (2000) *SMU L Rev* 1627, 1632. It is also common to obtain insurance for the attachment, priority and perfection of security interests to transfer the risks of failed financing statements from the secured creditor to the insurer. See J Murray, 'Sufficiency of Debtor's Name for Valid UCC Filing – Recent Cases' (2006) *Practicing Law Institute* 611, 632-633.

<sup>57</sup> T Janzen, 'Nationalize the Revised Article 9 Filing System: A Comparison of the Old Article 9 and Canadian Personal Property Filing Systems' (2001) 11 *Indiana Int'l Comp L Rev* 389, 410-411.

<sup>58</sup> S V Erp, 'The Cape Town Convention: A Model for a European System of Security Interests Registration?' (2004) *ERPL* 91, 98.

registry staff.<sup>59</sup> This process involves more time and cost as well as the possibility of errors both by the registrant (when submitting the data) and the registry staff (when entering it in the registry).<sup>60</sup> In contrast, the fully electronic International Registry is considered to be more efficient and secure because the lack of human intervention is thought to reduce the risk of human error in the registration data which may help preserve priority status of the registrant as well as ensure that a searching party can obtain reliable information in relation to the object.<sup>61</sup> In order to minimise the possibility of errors in the registration data, the registering party is encouraged to use drop-down menus provided by the system.<sup>62</sup> For example, the information relating to the manufacturer's name, generic model designation and serial number of the aircraft object can only be transmitted to the Registrar if the registrant selects relevant data from the drop-down menus provided by the system.<sup>63</sup>

### 2.2.2 Notice filing v transaction filing

The International Registry is based on notice filing rather than contractual document or transaction filing.<sup>64</sup> The latter usually involves filing of a copy of the contract creating a security interest.<sup>65</sup> For example, under the English Companies Act 2006, Part 25,<sup>66</sup> the document creating a charge which needs to be registered

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<sup>59</sup> R Cuming, 'Considerations in the Design of an International Registry for Interests in Mobile Equipment' (1999) *Unif L Rev* 275, 281.

<sup>60</sup> *Ibid* 281.

<sup>61</sup> However, it has been suggested that a purely electronic system may be too rigid and if it is not flexible enough to accommodate possible errors in the data submitted by the registrant, it may be commercially impractical. R Cuming, 'Article 9 North of #49: The Canadian PPS Acts and the Quebec Civil Code' (1996) 29 *Loyola of Los Angeles L Rev* 971, 983-984. To locate the relevant registration entry in the International Registry, exact information identifying the object is generally required. But what happens if the registering party mistakenly selected an incorrect element of the information identifying the object from the drop-down menu of the system, such as the name of the manufacturer? Once the search criteria are entered, the system will issue the searching party with a list of possible matches of the object sought by the searcher. The most probable or exact match will be highlighted for the searcher's attention, but it is still possible to select another close match in order to reveal whether this is the object which was actually sought by the searching party and which contains mistaken information entered by the registrant.

<sup>62</sup> J Atwood, 'The Status of the Mobile Equipment (Cape Town) Convention – Arrival of an International Registration System' (2006) 39 *UCC L J* 1 Art 3.

<sup>63</sup> Goode (n 11) 118.

<sup>64</sup> Art 17(2)(i), the Convention.

<sup>65</sup> G McCormack, *Secured Credit under English and American Law* (Cambridge, CUP 2004) 133.

<sup>66</sup> Replacing Companies Act 1985, Part 12.

together with the prescribed particulars<sup>67</sup> must be delivered to the Registrar within 21 days of the creation of the charge.<sup>68</sup> The Registrar is required to compare the charge document against the prescribed particulars and issue a certificate of registration which is considered to be conclusive evidence of the fact that the requirements as to the registration have been complied with.<sup>69</sup> This means that each transaction creating a charge must be separately registered and the whole credit relationship between the debtor and the creditor cannot be registered at a single registration session.<sup>70</sup> Failure to comply with this requirement may lead to the avoidance of the charge against the liquidator, administrator and any creditor of the company.<sup>71</sup> Having discovered that the object offered to it as collateral is already encumbered by a prior security, the prospective creditor can examine the documents creating such interest without the need to contact the previous creditor. For example, by checking the documents at the public registry, the creditor may be able to ascertain how much was borrowed by the debtor and what interest must be paid to the creditor. However, the documents creating the charge will not be able to reveal how much of the debt was already repaid to the creditor. As a result, the searcher may still have to contact the prior creditor in order to obtain all necessary information before the loan can be given to the debtor.<sup>72</sup>

Transaction filing systems may also be costly and difficult to maintain because the documents should be stored at the registry. For that reason, they were replaced in some jurisdictions by more flexible and convenient notice filing systems.<sup>73</sup> In a notice filing system under the Convention,<sup>74</sup> what is registered is

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<sup>67</sup> Prescribed particulars include such information as the name of the company creating a charge, the date of creation of the charge, the amount secured, short particulars of the property etc. S. 395(1) Companies Act 1985; See G McCormack, *Registration of Company Charges*, 2nd Edn (Jordans 2005) 6.33.

<sup>68</sup> See, generally, H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (Oxford, OUP 2007) Ch 8.

<sup>69</sup> G McCormack, 'Notice Filing versus Transaction Filing – a Comparison of the English and US Law of Security Interests' (2002) *Insolvency Law* 166, 168.

<sup>70</sup> G McCormack, 'Rewriting the English Law of Personal Property Securities and Article 9 of the US Uniform Commercial Code' (2003) *Comp Law* 69, 71.

<sup>71</sup> S. 874(1) Companies Act 2006. See also McCormack (n 67) 6.2-6.3; For a discussion on whether power to avoid a registrable, but unregistered charge is incompatible with the European Convention on Human Rights see J D Lacy, 'Company Charge Avoidance and Human Rights' (2004) *JBL* 448.

<sup>72</sup> Law Commission Consultation Paper N164, *Registration of Security Interests: Company Charges and Property other than Land* (London, TSO 2002) 50.

<sup>73</sup> Cuming (n 59) 278.

<sup>74</sup> Notice filing has its origins in Article 9 UCC. S. 9-502 lists the basic data which must be included in a financing statement (a registration or filing document). In order to be effective a financing statement must include the name of the debtor, the name of the secured party or its



basic information allowing a searching party to discover that a certain transaction may have given rise to an interest in the object as well as the names of the parties involved.<sup>75</sup> The searching party can then approach the creditors named in the certificate in order to obtain more detailed information in relation to such a transaction. This system has several advantages.<sup>76</sup> Since the registration data is only basic, confidential details of business arrangements between the debtor and its previous creditors may remain undisclosed.<sup>77</sup> The searching party can obtain relevant information by making further enquiries from the creditors named in the search certificate.<sup>78</sup> In addition, since the registration information is reduced to a bare minimum, the possibility of entering erroneous data is also reduced.<sup>79</sup> Next, since the International Registry is an electronically operated system, registering only basic information in relation to the object may be more cost efficient than having to digitalise and register whole documents creating an international interest.<sup>80</sup> Thirdly, the minimalistic approach of the notice filing means that the registration data may not reveal whether the interest was actually created or only intended to be created. This allows for the registration of a prospective international interest which can be accomplished before the agreement constituting the actual international interest is entered into.<sup>81</sup> The searching party will only be able to ascertain that a prior creditor may have an international interest in the object held by the debtor. The parties may agree for the prospective interest relating to a uniquely identifiable object to be registered while they

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representative and indicate the collateral covered by the financing statement. On filing and other modes of perfection see J White and R Summers, *Uniform Commercial Code*, 5<sup>th</sup> edn (West Group 2000) Ch 22.

<sup>75</sup> McCormack (n 70) 71. See also D Beran, 'Financing Statements, Descriptions, Collateral and Confusion: Arkansas Courts Tackle the New Article 9' (2005) 57 *Arkansas L Rev* 951.

<sup>76</sup> For a view that despite its advantages, the switch to notice filing from contractual document or transaction filing may not be necessary, because the latter achieves most of the objectives of the former see McCormack (n 69) 168.

<sup>77</sup> R Cuming, 'The International Registry for Interests in Aircraft: An Overview of its Structure' (2006) *Unif L Rev* 18, 26.

<sup>78</sup> *Ibid* 28. However, previous creditors are not under an obligation to respond to the inquiry of the searcher. For a different position under the Canadian law see I Davies, 'The Reform of Personal Property Security Law: Can Article 9 of the US Uniform Commercial Code be a Precedent' (1988) *ICLQ* 465, 489.

<sup>79</sup> Cuming (n 59) 279.

<sup>80</sup> *Ibid* 278.

<sup>81</sup> In contrast, this result cannot be achieved under the English transaction registration systems since documents creating a charge should be submitted to the Registrar. This and other unsatisfactory features of transaction registration system prompted calls for reform along the lines of filing under Article 9 UCC. For a discussion of the proposed reform see M Lawson, 'The Reform of the Law Relating to Security Interests in Property' (1989) *JBL* 287.

negotiate the terms of the agreement creating the actual international interest.<sup>82</sup> Once the international interest is created, there will be no need to re-register it and the priority of the creditor will date back to the moment when the prospective interest was registered.<sup>83</sup> Finally, because registration under notice filing is not linked to a particular transaction or a document creating the international interest it may be possible to cover further advances by the initial registration.<sup>84</sup> For example, a creditor and the debtor may agree to register an international interest to secure the repayment of the loan provided for the purpose of acquiring a uniquely identifiable airframe for the debtor. After a year (and while the debtor is still in the process of repaying the existing debt) the parties may agree for a new loan to be given to the debtor. This loan can also be secured by the same airframe held by the debtor. While it should be possible to register a new international interest in relation to the repayment of the new debt, the parties may decide that the previous registration shall cover the new obligation. This way, the creditor can ensure that its previous priority position will not be trumped by another creditor who may have obtained its interest in between the first and the second loan. This should be the case because the Convention provides that the priority of the first registered interest can extend to any future advances secured by the same object, even if the holder of this interest is aware of the existence of the competing interest at the time of making the future advance.<sup>85</sup>

### 2.2.3 Asset- based International Registry

The International Registry is asset-based and all registrations and searches in it must be conducted against a uniquely identifiable object.<sup>86</sup> This approach may be contrasted with other registration systems whereby the main criterion used for the purposes of effecting and searching a registration is the name of the debtor. Debtor-based systems do not have to be tied to a specific object which enables the registrant to register a security interest in future or after-acquired property of the

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<sup>82</sup> This option would not be possible under the transaction filing because under such a system each registration must relate to a particular existing document creating a charge. In other words, it would be necessary first to conclude an agreement creating a charge and then register and not vice versa.

<sup>83</sup> Art 19(4), the Convention.

<sup>84</sup> Harris (n 1) 537.

<sup>85</sup> Art 29(2)(b).

<sup>86</sup> Goode (n 11) 194.

debtor. In contrast, in the asset-based system, the registering party can only register an international interest in the existing object which can be uniquely identified at the time of the registration. It is for this reason that the Convention and Aircraft and Luxembourg Protocols require the object to be uniquely identified at the stage when the registration is made in the International Registry.<sup>87</sup> Debtor-based systems are well suited for registration of interests in such collateral as inventory or accounts because they obviate the need to make a new registration each time the collateral is changed.<sup>88</sup> However, such systems can offer the secured creditor 1 little certainty when debtor A changes its name to B and grants a new security interest in the same collateral to the secured creditor 2. Before granting a loan, SC2 will search a register against the name of the debtor known to it (that is, B) and will not be able to discover SC1's interest. Even if the debtor does not change its name or sell the collateral to another party, a single mistake in the name of the debtor, such a misspelling by one letter or use of a nick-name instead of a legal name, may preclude a proper search revealing any registered interests in the debtor's property.<sup>89</sup> These problems can be avoided in the asset-based system which may reveal all potentially existing interests in the object irrespective of any changes in the debtor's name or identity. Since the objects governed by the Convention are of high value and can be uniquely identified by serial numbers, asset-based system is better suited for registration of interests in these objects than the debtor-based system.

Finally, the Aircraft Protocol treats airframes and aircraft engines as separate objects. For this reason, if a transaction involves registration of an interest in both airframe and an engine attached to it, the registering party will

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<sup>87</sup> Goode (n 48) 181.

<sup>88</sup> Cuming (n 61) 981.

<sup>89</sup> Misspellings of the debtor's name or use of incorrect names in financing statements are a major problem under Article 9 UCC filings. If the mistake is such that the correct filing cannot be located, it invalidates the financing statement of the secured creditor and results in loss of priority. This problem generated some considerable case law. See *Clark v Deere and Co (In re Kinderknecht)* 308 B.R. 71 (10<sup>th</sup> Cir. B.A.P. 2004) where the use of a debtor's nickname Terry instead of its legal name Terrance by the secured creditor had an invalidating effect on the financing statement. See also *In re FV Steel and Wire Co.*, 310 B.R. 390; *In re Nittolo Land Dev. Ass'n*, 333 B.R. 237 (Bankr. S.D.N.Y. 2005) where a financing statement reciting the debtor's name as 'Nittolo Land Development Associates, Inc' instead of the correct name of 'Nittolo Land Development Association, Inc' was held to be invalid. Similarly, the decision in *Pankratz Implement Co. v Citizens Nat'l Bank*, 281 Kan 209, 130 P. 3d 57 (Kan. Sup.Ct., 2006) leaves secured creditor no room for error in the debtor's name. In this case, only one letter was omitted and instead of Rodger House, the debtor's first name was misspelled as Roger which had the effect of invalidating the financing statement.

have to effect separate registrations to cover both objects.<sup>90</sup> In contrast, interests in railway engines are not separately registrable since they constitute part of railway rolling stock.<sup>91</sup>

### 2.3 The Supervisory Authority and the Registrar

There will be different International Registries where interests held in various categories of objects governed by the Convention can be recorded.<sup>92</sup> Each registry will be operated by the Registrar appointed and dismissed by the Supervisory Authority.<sup>93</sup> In the case of aircraft objects, the Supervisory Authority is the Council of ICAO<sup>94</sup> and the Registrar, which is appointed for the period of five years,<sup>95</sup> is Aviareto. The Supervisory Authority is responsible for the establishment of the International Registry and for ensuring the continuity of its effective operation in the case of a change of the Registrar.<sup>96</sup> It is for this reason that the Supervisory Authority is given the ownership of all proprietary rights in the data base and archives of the International Registry.<sup>97</sup> The ownership of proprietary rights vested in the Supervisory Authority is essential for ensuring that the new Registrar is assigned all necessary rights for the effective operation of the registry.<sup>98</sup> Other functions of the Supervisory Authority include publication of regulations, establishment of administrative procedures for making complaints concerning the operation of the registry, providing guidance to the Registrar at its request and review of the fees associated with the services of the registry.<sup>99</sup>

In the case of railway objects, in relation to which the registry is not yet in operation, a slightly different structure was adopted. The Supervisory Authority will consist of representatives of at least ten Contracting States to the Luxembourg Protocol and will be assisted in the performance of its functions by the

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<sup>90</sup> Cuming (n 77) 22.

<sup>91</sup> Goode (n 48) 21.

<sup>92</sup> Art 16(2).

<sup>93</sup> Art 17 (2)(b).

<sup>94</sup> The Cape Town Diplomatic Conference invited ICAO to act as the Supervisory Authority for aircraft objects registry. Resolution No. 2, Annex VI in Goode (n 11).

<sup>95</sup> Art XVII(5) Aircraft Protocol.

<sup>96</sup> Art 17(2)(a), (c).

<sup>97</sup> Art 17(4).

<sup>98</sup> Goode (n 11) 199.

<sup>99</sup> Art 17(2).

Secretariat.<sup>100</sup> The Intergovernmental Organisation for International Carriage by Rail (OTIF) will act as the Secretariat and its headquarters in Berne (Switzerland) shall be used by the Supervisory Authority during the discharge of its functions.<sup>101</sup>

The Supervisory Authority shall have international legal personality where not already possessing it and its employees shall enjoy immunity from legal or administrative processes.<sup>102</sup> This means that the Supervisory Authority has a legal personality distinct from its members and can enter into agreements with other parties as may be necessary for the performance of its functions under the Convention and the relevant Protocol.<sup>103</sup> The Supervisory Authority is exempt from taxes and may enjoy other privileges provided by the host State in which it is located.<sup>104</sup> The assets, documents, data bases and archives of the International Registry shall be inviolable and immune from seizure, but such immunity may be waived by the Supervisory Authority when, for example, a person making a claim against the Registrar needs to access this information in order to be able to support its claim.<sup>105</sup>

Unlike the Supervisory Authority, the Registrar is not immune from legal and administrative processes and is liable for compensatory damages for loss suffered by a person directly resulting from an error of the Registrar or from a malfunction of the International Registry.<sup>106</sup> But, the liability of the Registrar is not absolute and the damage caused by the malfunction of the system which occurred as a result of an event of inevitable and irresistible nature that could not have been prevented will not be within liability of the Registrar.<sup>107</sup> Similarly, the Registrar is not liable for any factual inaccuracy it receives or transmits in the form in which such information was originally received.<sup>108</sup> Since the International Registry is an electronically operated system involving no human intervention at the receiving end, it is difficult for the Registrar to check external information

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<sup>100</sup> Art XII Luxembourg Protocol.

<sup>101</sup> G Kafka, 'The Supervisory Authority and its Secretariat According to the Luxembourg Protocol' (2007) *Unif L Rev* 554-555.

<sup>102</sup> Art 27(1).

<sup>103</sup> Goode (n 11) 218.

<sup>104</sup> Art 27(3).

<sup>105</sup> Art 27(4),(5),(6). See also Goode (n 11) 219.

<sup>106</sup> Art 28(1).

<sup>107</sup> Art 28(1). See, generally, H Bollweg and K Schnell, 'Liability of the Registrar for the Registration of International Interests Pursuant to the Luxembourg Protocol' (2007) *Unif L Rev* 559.

<sup>108</sup> Art 28(2).

transmitted to it by the other party. For this reason, the Registrar is entitled to assume the correctness of the information and should not be liable if, for example, the information submitted by the registrant contains errors in relation to the identification of the object.<sup>109</sup> In the case of railway objects, the Registrar's liability for loss cannot exceed the value of the object to which the loss relates and should be within the limit of liability of 5 million Special Drawing Rights in any calendar year or such greater amount which can be determined by the Supervisory Authority.<sup>110</sup> Finally, the Registrar is required to cover its liability by insurance or a financing guarantee to the extent determined by the Supervisory Authority.<sup>111</sup> In relation to aircraft objects, the amount of insurance or financing guarantee should not be less than the maximum value of an aircraft which is presently set at \$US 30m.<sup>112</sup>

### 3. Objectives of registration and interests which can be registered in the International Registry

#### 3.1 Objectives of registration

The International Registry is unique in that for the first time it is possible to register security and other international interests in aircraft objects in a registry which is not tied to any specific domestic jurisdiction and can be accessed from anywhere in the world. The fact that such a registry was established and operates successfully can serve as a powerful impetus to those jurisdictions where a registry recording security interests in aircraft objects does not yet exist.<sup>113</sup> An

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<sup>109</sup> Goode (n 11) 221.

<sup>110</sup> Goode (n 48) 206.

<sup>111</sup> Art 28(4). See H Rosen, 'The Luxembourg Rail Protocol: A Major Advance for the Railway Industry' (2007) *Unif L Rev* 427, 435-438.

<sup>112</sup> Goode (n 11) 222.

<sup>113</sup> For example, in Canada, an aircraft can be registered in the Canadian Civil Aircraft Register for the purpose of identification of persons who have legal custody of an aircraft. The main objective of such registration is facilitation of safety regulations. But proprietary interests in aircrafts cannot be registered in this Registry. There was some debate resulting in draft legislation in relation to the establishment of a central registry where security interests in aircraft objects could be registered, but the legislation was not enforced. See D Fiorita, 'The Registration of Aircraft and the Recordation of Security Interests in Aircraft (Canadian Practice)' (1993) 18 *Oklahoma City U L Rev* 57. In contrast, in the UK it may be difficult to check the title of the mortgagor, since there is no register recording title to an aircraft and engines, but it should be relatively easy to find out about any registrable security interests in such objects because the UK has a register of aircraft

effective registration system was once called ‘the centre pole that holds up the entire personal property security tent’ and it was suggested that ‘without such a system, lenders would go wary, commerce would be hobbled, and the manifold commercial ends that are met by commercial lenders would be stunted, rendered more costly, or stymied together’.<sup>114</sup> At the same time, registration of security interests in personal property and in aircraft objects in particular, is not a universally accepted phenomenon and some jurisdictions do not have registries to record security interests at all.<sup>115</sup> The fact that secured financing can still flourish in such jurisdictions may suggest that there is no need for the existence of the International Registry since the information available there can perhaps be obtained from the debtor or examination of financing accounts of the company or in some other way.<sup>116</sup> The examination of the main objectives of the International Registry may help ascertaining whether its establishment was warranted and why a registering party would wish to record its interest in the aircraft object in it.

### 3.1.1 Notice of possible existence of the registered interest

One of the main purposes of registration in the International Registry is to provide notice of possible existence of the registered interest to third parties.<sup>117</sup> Before extending the loan, the creditor may want to know whether the airframe offered to it as a security is already encumbered by a previous international interest.<sup>118</sup> After the loan is granted, the creditor may need to ensure that subsequent creditors will discover its interest in the airframe before they provide the debtor with any new funds.<sup>119</sup> The creditor may obtain the information regarding any previous claims

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mortgages. See P Thorne, ‘Aircraft Mortgages’ in N Palmer and E McKendrick (eds), *Interests in Goods*, 2<sup>nd</sup> Ed (LLP, London 1998) 711.

<sup>114</sup> J White, ‘Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules’ (1995) 79 *Minn L Rev* 529, 530.

<sup>115</sup> For example, there is no central registry for security interests in tangible and intangible movables in such countries as Germany, the Netherlands, or in Austria, Switzerland and Russia. See Wood (n 2) 155.

<sup>116</sup> WJ Gough, *Company Charges* (Butterworths 1978) 204.

<sup>117</sup> R Castillo-Triana, ‘The Relevance of the Luxembourg Protocol for Central and South America’ (2007) *Unif L Rev* 461, 467.

<sup>118</sup> Similarly, Buckley J noted in *Re Jackson and Bassford Ltd* [1906] 2 Ch. 467, at 476, that the object of registration is that ‘those who are minded to deal with the limited company shall be able, by searching a certain register, to find whether the company has encumbered its property or not.’

<sup>119</sup> For a similar view see *Re Cardiff Workmen’s Cottage Co Ltd* [1906] 2 Ch. 627, at 629, where it was noted that the purpose of registration is ‘to ensure the means of notice to those who contemplate giving credit to the company’.

in the object and give notice to subsequent creditors by searching the International Registry and by registering its own interest in the airframe in it. Similarly, a trustee in bankruptcy, a liquidator or a creditor who obtained a court order for the satisfaction of the debt owed to it by the company, may wish to search the register in order to establish which of the creditor claims must be honoured first or how heavily is the asset encumbered.

One question which may arise at this point is what can the notice of the registered interest tell the searching party? First, a registration in the International Registry does not guarantee that the international interest exists.<sup>120</sup> A search certificate issued to the searching party will only indicate that the creditor named in the registration has acquired or intends to acquire an international interest in the object.<sup>121</sup> The search certificate will not reveal whether what is registered is an actual international interest or a prospective international interest even if this can be ascertained from other registered information.<sup>122</sup> The neutral language of the certificate allows the parties to register a prospective interest while the terms of the security agreement are being negotiated. Once the agreement has been concluded and provided that the registered data is sufficient to support the registration of the international interest, there will be no need to register a new international interest.<sup>123</sup> For example, in the case of a security agreement, the parties may register a prospective international interest in relation to uniquely identifiable aircraft engine. Once the chargor obtains the power to dispose of the object, the registered prospective interest will automatically transform into the registered international interest. Although this means that the searching party will not be able to ascertain from the certificate alone whether the registration refers to the prospective or actual international interest, such registration may allow the registering party to secure its priority at the stage of negotiations with the debtor. This should be the case because the Convention treats the interest which is first registered as a prospective interest and later becomes an international interest as registered from the time of registration of the prospective interest and not from the time of its creation as an actual international interest.<sup>124</sup> Since priority of

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<sup>120</sup> Goode (n 11) 49.

<sup>121</sup> Art 22(3).

<sup>122</sup> Art 22(3).

<sup>123</sup> Art 18(3). See also Goode (n 11) 202.

<sup>124</sup> Art 19(4).



competing interests is determined by order of registration,<sup>125</sup> the registration of a prospective interest may allow the creditor to secure its claim at an earlier stage. At the same time, the certificate will provide the searcher with names and addresses of the creditors. The searching party should then be able to contact them in order to obtain more information in relation to the nature of the registered interest.

Secondly, the registration is not a proof that the international interest was validly created. Registration is not necessary for the creation of the international interest and, for this reason, cannot be used as a proof of its existence.<sup>126</sup> If the formal requirements for the creation of the international interest are not met,<sup>127</sup> the registration of such an interest will simply be ineffective under the Convention. It is, of course, possible to register an interest (as a prospective interest) before the agreement creating it is entered into. But should it later transpire that, for example, the negotiations between the parties did not result in the creation of the actual international interest, or that the secured obligations cannot be determined from the security agreement, or that chargor did not obtain the power to dispose of the object, the security agreement will not be considered as validly created. Consequently, the registration of the interest arising from such an agreement will also be invalid.

Next, in order to effect a registration, the registrant must obtain consent of the other party.<sup>128</sup> However, the existence of the registration cannot be used as a proof that such consent was validly obtained. This flows from the electronic nature of the International Registry: since the process of registration and search involves no human intervention, the Registrar cannot evaluate and assess the facts external to the transmitted data.<sup>129</sup> It is for this reason that the Registrar is not under a duty to enquire whether consent to registration has in fact been given or is valid.<sup>130</sup> Once consent to effect a registration is electronically transmitted and

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<sup>125</sup> Art 29(1).

<sup>126</sup> Goode (n 11) 49. The position is different under Croatian law where both creation and priority are preconditioned and determined at the moment of registration of a security interest. See T Jocić, 'The Rail Protocol and Croatian Secured Transactions Law' (2007) *Unif L Rev* 489, 503.

<sup>127</sup> Art 7. For more detailed examination of the formal requirements necessary for the creation of the international interest see Chapter II.

<sup>128</sup> Art 20(1).

<sup>129</sup> Goode (n 11) 201.

<sup>130</sup> Art 18(2).

provided that all other necessary requirements are met, the Registrar will have to effect the registration. If consent was not in fact validly obtained, the registration will be invalid, even if this cannot be ascertained from the registry.<sup>131</sup>

Finally, the registration is not a guarantee that the registered interest was not discharged. Once the obligations secured by the security agreement have been performed, the security interest ceases to exist and the interest held by the debtor in the object becomes unencumbered. Similarly, when the conditions of transfer of title under a registered title reservation agreement are fulfilled, the title held by the seller is transferred to the conditional buyer. In such cases, the holder of the registered interest, i.e. the secured creditor or conditional seller, has to arrange for the interest to be discharged from the registry.<sup>132</sup> The discharge must be procured after a written demand by the debtor is delivered to the address of the registrant.<sup>133</sup> In the case of aircraft objects, the discharge should occur no later than five working days after receipt of the demand.<sup>134</sup> Since there is a five day period during which the discharge can be reflected in the International Registry, this means that some registered interests which appear to be current, may have in fact already ceased to exist.

To reiterate, the registration in the International Registry cannot amount to a notice of existence of the registered interest, or to a proof that the registration was validly effected, nor can it be a guarantee that the registered interest was validly created and was not discharged. The only purpose of such a notice is to draw to the attention of the searching party that a registered interest may have been created. It is then for the searching party to enquire from the creditors named in the registration information about the status of their interest in the object held by the debtor.

One possible criticism which may arise in this respect is that the information given in the registry is too vague to be of any value. Effectively, it is merely a list of possible creditors of the debtor who may have some interest in the object. Searching the registry may not be sufficient to make a decision in relation to the loan for the debtor. The searching party will still have to approach creditors named in the search certificate. Since the Convention does not impose a duty on

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<sup>131</sup> Art 19(1).

<sup>132</sup> Art 25(1).

<sup>133</sup> Art 25(1).

<sup>134</sup> Art XX(2), the Aircraft Protocol.

the registered creditors to disclose any information to the searching party, the latter may also need to run an independent credit check on the debtor to clarify its financial position and assess its ability to repay the debt.

Another possible criticism of the system is that not only may the list of registrations provided by the registry be inconclusive, but it may also not be comprehensive. Some of the registered interests may appear as current, but in fact never came into existence or were already discharged at the time of the search. Other interests may not appear on the register because they cannot be registered and yet be binding on the searching party. Although the general rule is that a registered interest has a priority over an unregistered interest even if the holder of the former knows of the existence of the latter,<sup>135</sup> this rule is subject to three exceptions. The first exception concerns non-consensual non-registrable rights or interests in relation to which a Contracting State has made a declaration under Article 39 of the Convention. Examples of such rights and interests include non-consensual liens on aircraft for unpaid navigation charges, taxes or repairs. Although the searcher will not be able to find these interests on the register, they will be treated in priority to any registered international interests.<sup>136</sup> But the Convention does not leave the searching party with no means of discovering the existence of such rights and interests. The searcher may be able to find out about their possible existence by making a separate search at the International Registry revealing any declarations made by Contracting States.<sup>137</sup> Therefore, there is no need to investigate whether the domestic law of a Contracting State provides that certain non-consensual, non-registrable rights or interests are treated in priority to registered interests and the International Registry can serve as a central point of inquiry for this purpose. If the search does not reveal a declaration, the searching party may be entitled to assume that such rights and interests will not be able to trump its priority in the debtor's insolvency. Finally, the scope of the Article 39 exception is limited to those rights and interests, which under the law of the Contracting State, have priority over an interest equivalent to the international

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<sup>135</sup> Art 29(1).

<sup>136</sup> Goode (n 11) 256.

<sup>137</sup> S. 7.5, the Regulations.

interest, namely, to the interests of chargee, conditional seller and lessor.<sup>138</sup> In contrast, some other domestic registration systems have much longer lists of interests which do not require registration and can still bind a searching party. For example, Section 9-309 of Article 9 UCC contains a list of various transactions, such as purchase money security interests, sales of payment intangibles, promissory notes and assignment of health care receivables which do not have to be filed or registered in order to obtain priority and are, generally, automatically perfected once attachment is complete.<sup>139</sup> Similarly, English law does not require registration of pledges, liens, hire purchase, retention of title agreements and leases.<sup>140</sup> Holders of such interests enjoy priority because they are either in possession or are owners of the object and can, in principle, claim it back in the case of the debtor's insolvency.<sup>141</sup> Despite the fact that domestic registration systems recognise that there may be various non-registrable rights and interests which can still bind a registered secured creditor, the advantages of a central public registry seem to outweigh this inconvenience and so far its users have not called for its abolition.<sup>142</sup>

The second exception to the general rule that the registered interest should be treated in priority to an unregistered interest relates to the position of a conditional buyer or lessee under the Convention. If a conditional seller or lessor enters into a reservation of title or a leasing agreement, the conditional buyer or lessee will not have a registrable interest and, for this reason, will not be able to protect itself against the creditors of conditional seller or lessor.<sup>143</sup> To shield the conditional buyer or lessee from possible claims to the object, which may come from a secured creditor of a defaulting conditional seller or lessor, the Convention provides the following.<sup>144</sup> If the conditional seller or lessor registers its interest before its creditor registers its own interest in the International Registry, the

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<sup>138</sup> See Comments to the Draft Convention and the Draft Protocol (Presented by the United States) in Diplomatic Conference to Adopt a Mobile Equipment Convention and an Aircraft Protocol: Acts and Procedures (UNIDROIT, Rome 2006) 180.

<sup>139</sup> On automatic perfection see White and Summers (n 74 ) 758-778.

<sup>140</sup> McCormack (n 70) 76.

<sup>141</sup> J D Lacy, 'Constructive Notice and Company Charge Registration' (2001) *Conveyancer and Property Lawyer* 122, 124; I Davies, 'Reservation of Title Clauses in France' (1991) *Int'l Banking Law* 417.

<sup>142</sup> White (n 114) 530.

<sup>143</sup> R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) *Bond L Rev* 9, 15.

<sup>144</sup> Goode (n 143) 15.

interest of the conditional buyer or lessee will be protected against the claims of the creditor.<sup>145</sup> The effect of this rule is that the registered interest of the creditor will be postponed to the unregistered interest of conditional buyer or lessee. But this exception will only come into operation if conditional seller or lessor registers its interest ahead of its creditor. In this case, the creditor will have an opportunity to search the registry before granting a loan to the conditional seller or lessor and find out about the existence of conditional sale and leasing agreements.<sup>146</sup> This can justify protection of the interests of conditional buyer and lessee granted to them by the Convention. Conversely, if the creditor manages to register its interest first, the conditional buyer and lessee's interest will no longer be protected.<sup>147</sup>

The final exception to the general rule of priority of a registered interest over an unregistered interest relates to the treatment of the outright buyer of an object. An outright buyer of the object acquires its interest in it free from an unregistered interest even if it has actual knowledge of it.<sup>148</sup> Conversely, the buyer's interest in the object will be subjected to the interest registered at the time of the acquisition of that interest.<sup>149</sup> At first it may not be apparent why this rule amounts to an exception to the general rule of priority of registered interest over the unregistered one: the buyer takes free from unregistered and subject to registered interests in the objects existing at the time of the acquisition. But the effect of this provision is that the buyer is given priority over an existing interest which is not registered until after the buyer's acquisition of the object.<sup>150</sup> For example, if the seller grants a security interest to a secured creditor and sells the object to the buyer before the interest of the secured creditor is registered, the buyer will take it free from the security interest even if it is later properly registered. However, this exception implies that the seller has power to dispose of the object.<sup>151</sup> When the seller sells the object to the buyer, the seller's power to dispose of it will be extinguished. Consequently, any grant of security and its registration by the seller's secured creditor after the sale to the buyer will not have any effect on it. This will not be the result of the exception, but will flow from the

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<sup>145</sup> Art 29(4).

<sup>146</sup> R Goode, 'The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing' (2003) 36 UCC L J 2 Art 1.

<sup>147</sup> Art 29(4)(b).

<sup>148</sup> Art 29(3)(b).

<sup>149</sup> Art 29(3)(a).

<sup>150</sup> Goode (n 11) 225.

<sup>151</sup> Ibid 225.

lack of validity in the creation of the security interest. Finally, the exception of the outright buyer does not apply to aircraft objects because the interest of such a buyer is made registrable by Aircraft Protocol.<sup>152</sup> Consequently, priority status of the buyer of an aircraft object will be determined by the order of registration.

Exceptions to the general rule that the registered interest is superior to an unregistered one are widely accepted in many domestic registration systems<sup>153</sup> and may not be a novelty to the users of the International Registry. It may also be suggested that the information provided by a notice filing registry need not be perfect or detailed in order to be valuable.<sup>154</sup> As long as it provides preliminary information and enables the searching party to ask relevant questions, such as who the creditors of the debtor are and what is the nature and extent of their registered interests, the system may be commercially acceptable.<sup>155</sup> The additional credit and other financial checks will still be required, but the high value of aircraft objects and sums of loans involved may justify thorough inquiries of the creditor.

### 3.1.2 Registration and priorities

The registration system plays a vital role in determining priorities under the Convention.<sup>156</sup> Generally, a valid registration ensures the priority of the international interest over any subsequently registered and unregistered interest.<sup>157</sup> This remains the case even if the holder of the first registered interest had actual knowledge of the other interest.<sup>158</sup> For example, if SC2 knew that the debtor granted SC1 a charge in an airframe and manages to register its security interest in the International Registry before SC1 registers its interest, SC2 will enjoy priority

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<sup>152</sup> Art III.

<sup>153</sup> Goode (n 143) 15.

<sup>154</sup> P Alces, 'Abolish the Article 9 Filing System' (1995) 79 Minn L Rev 679, 695.

<sup>155</sup> Alces (n 154) 695.

<sup>156</sup> This is not the case under English registration system where the main purpose of registration of charges is to provide information about their existence to third parties. For a view that this should be changed and priorities between competing creditors should be determined by the order of registrations see J D Lacy, 'Constructive Notice and Company Charge Registration' (2001) Conveyancer and Property Lawyer 122. In contrast, the new legislation in the British Virgin Islands stipulates that a registered charge will enjoy priority over a subsequently registered and unregistered charge. See S. 166 of the Business Companies Act 2004. For a reform in the area of registration of security interests in personal property brought by the Business Companies Act 2004 see D Smith and R Woodman, 'Legislative Comment. British Virgin Islands: Security - Registration' (2008) J Int'l Bank L Regul.

<sup>157</sup> Art 29(1). Similarly, Article 9 UCC prescribes that priorities between competing security interests are determined by the order of their filing. See McCormack (n 70) 72.

<sup>158</sup> Art 29(2)(a).

over the subsequently registered interest of SC1. By searching the registry before extending the loan, the creditor may assess how its priority status would relate to other registered interests which may help deciding whether to grant a loan to the debtor and on what terms. If the creditor discovers that its security interest will be the first to be registered, it may assume that in the case of the debtor's insolvency, it will, generally, be able to enforce its security in priority to any subsequently registered or unregistered interest in the same object. Consequently, the creditor may be relatively certain that its interest will not be postponed to other creditors and that the debt will be repaid. If the search of the registry reveals that the object is already encumbered by previously registered interests, the creditor's place in the queue of holders of such interests may be shifted. This may increase the risk of non-repayment and result in increased cost of credit for the debtor but it will still help the creditor to clarify its priority status.

Since the first creditor to register is generally superior to subsequently registered and unregistered interests, registration not only allows the creditor to determine its priority position, but also to validate its claim against other creditors.<sup>159</sup> Once the registration is effected and becomes searchable, subsequent creditors will treat it as an effective registration and accept its superiority.<sup>160</sup> This explains the importance of the existence of the International Registry: the information contained in the registry is not there to simply provide a notice to third parties, but is valuable in itself because it allows the creditor to publicly mark its claim in the object and to ensure that it will be recognised by subsequent creditors of the debtor.

Finally, registration of the international interest in the International Registry prior to the commencement of the insolvency proceedings against the debtor will ensure the effectiveness of that interest on insolvency.<sup>161</sup> This protection shields not only international interests, but also other registrable interests such as notices

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<sup>159</sup> J Ayer, 'Some Comments on Bowers' (1995) 79 Minn L Rev 745, 747.

<sup>160</sup> Registration of the international interest in a registry may also serve as a form of insurance against a risk that a debtor will impose secret liens on the object which may preclude the creditor from asserting its claim. See McCormack (n 65) 136.

<sup>161</sup> Art 30(1).

of national interests<sup>162</sup> and registrable non-consensual right and interests<sup>163</sup> which, once they are registered, are treated as international interests.<sup>164</sup>

### 3.2 Interests which can be registered in the International Registry

Article 16(1) of the Convention lists the types of interests which can be registered in the International Registry. In addition, the Aircraft Protocol states that outright sale and prospective sale of aircraft objects can be registered and treated as international and prospective international interests for the purposes of priority.<sup>165</sup> In contrast, the Railway Protocol indicates that a notice of sale can be registered, but such registration can only be effected for information purposes and will have no effect under the Convention.<sup>166</sup> The following section will examine the types of interests which can be registered in the International Registry.

a) International interests, prospective international interests and registrable non-consensual rights and interests

International interests<sup>167</sup> and prospective international interests

The International Registry is not a title registry. This is why in relation to such international interests as title reservation and leasing agreements, it should be noted that what is registered is not the information guaranteeing the ownership of the creditor, but rather the interests held by it as a conditional seller or lessor.<sup>168</sup> For this reason, the interests of conditional seller and lessor do not become registrable as international interests until conditional sale or leasing agreement have been concluded.<sup>169</sup> It is also possible to register a prospective international interest in the International Registry. As noted above, registration of a prospective interest may help the parties to preserve the priority of the creditor while the terms

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<sup>162</sup> Art 50(2).

<sup>163</sup> Art 40.

<sup>164</sup> Goode (n 11) 231.

<sup>165</sup> Art III. See also Cuming (n 37) 30.

<sup>166</sup> Goode (n 48) 84.

<sup>167</sup> For more detailed information on the nature of the international interest see Chapter I.

<sup>168</sup> Cuming (n 77) 22.

<sup>169</sup> Goode (n 11) 196.



of the agreement creating the international interest are being negotiated.<sup>170</sup> Once all requirements for the creation of the international interest are met and provided that the information registered in the registry is sufficient to support this interest, there will be no need to procure a new registration and the prospective international interest will automatically turn into the actual international interest.<sup>171</sup> For this reason, the search certificate presented to the searching party will also be expressed in neutral terms, merely stating that the creditor acquired or intends to acquire an international interest.<sup>172</sup> It is then up to the searching party to ascertain from the parties named in the certificate whether the registered interest is a prospective or an actual international interest.<sup>173</sup>

### Registrable non-consensual rights and interests

Non-consensual rights and interests do not arise as a result of an agreement between the parties. Instead, they are conferred by the law of a Contracting State which has made a declaration either under Articles 39 or 40 of the Convention.<sup>174</sup> Under Article 40, the Contracting State may deposit with the Depository of the Protocol a declaration listing the categories of non-consensual rights and interests which shall be registrable in the International Registry. In this case, such rights and interests can be registered under Article 16(1)(a) and will be regulated as if they were an international interest.<sup>175</sup> This means that if a registrable non-consensual right is registered in the International Registry it will enjoy priority over any other subsequently registered international interest and unregistered interest. If a registrable non-consensual right or interest is not registered, its priority will be postponed to registered interests. A declaration under Article 40 must specifically list all non-consensual rights and interests covered by it and a general description will not be sufficient.<sup>176</sup> Examples of such rights and interests include liens in favour of airline employees for unpaid wages arising prior to the

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<sup>170</sup> Goode (n 11) Illustration 13, 206. The same result can be achieved under Article 9 UCC. See McCormack (n 69) 168.

<sup>171</sup> R Goode, 'The International Interest as an Autonomous Property Interest' (2004) ERPL 18, 24-25.

<sup>172</sup> Art 22(3).

<sup>173</sup> Goode (n 171) 25.

<sup>174</sup> Art 1(s), (dd).

<sup>175</sup> Art 40.

<sup>176</sup> As of December 2009, 16 Contracting States have made declarations under Art 40.

time of a declared default by the airline,<sup>177</sup> rights of a person obtaining a court order permitting attachment of an aircraft object in partial or full satisfaction of legal judgment<sup>178</sup> and liens or other rights of a state entity relating to taxes or other unpaid charges.<sup>179</sup> One advantage of making a declaration under Article 40 is that once these non-consensual rights and interests are registered, they can be easily discovered by a searching party which may help it ascertain its priority position. Secondly, since these rights and interests are registrable, the registry can present a more complete picture of encumbrances burdening the object.

Alternatively, a Contracting State can make a declaration under Article 39 of the Convention in relation to those non-consensual rights and interests which are not covered by Article 40 declaration and, for this reason, cannot be registered in the International Registry. Article 39 allows for two types of declarations to be made by a Contracting State. First, it is possible to declare, either generally or specifically, categories of non-consensual rights and interests which under the State's law are treated in priority to an interest equivalent to that of a holder of the registered international interest.<sup>180</sup> In other words, in order to gain priority over registered international interests under the Convention, non-registrable non-consensual rights and interests must enjoy priority over security interests, retention of title and leasing agreements under the domestic law of a Contracting State.<sup>181</sup> Failure to make a declaration or to list all non-registrable non-consensual rights and interests will result in loss of priority to registered international interests reflecting the general rule that first to register gets priority.<sup>182</sup> English law can provide some examples of the types of non-consensual rights and interests that may be covered by this declaration. In one case, an air transport operator executed a duly registered debenture, creating a fixed charge over company's

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<sup>177</sup> See Declaration by Malaysia available at: <<http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/article40.htm>>.

<sup>178</sup> See Declaration by Oman available at: <<http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/article40.htm>>.

<sup>179</sup> See Declaration by the Republic of South Africa at: <<http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/article40.htm>>.

<sup>180</sup> Art 39(1)(a).

<sup>181</sup> Goode (n 11) 256.

<sup>182</sup> Ibid 257.

realty and floating charge over all other property in favour of a bank.<sup>183</sup> The company owed a debt to Manchester Corporation for airport charges relating to particular landings and departures of an aircraft. When the aircraft landed, it was detained by the corporation in accordance with s 35 of the Manchester Corporation Act 1965. The company contended that, among other things, the right of detention should not have been exercised because the registered charge should be treated in priority to it. The court disagreed stating that non-registrable statutory right of detention exercised by the corporation had priority over the registered charge of the bank.<sup>184</sup> In another case, two airport operators detained aircrafts of an insolvent charter airline for the sums owed in respect of landing, fuel and other airport charges.<sup>185</sup> These statutory rights of detention arose under s 88 of the Civil Aviation Act 1982 and were considered by the court to amount to ‘a lien or other security.’<sup>186</sup>

Because these non-consensual rights and interests cannot be registered, the holder of a registered international interest may only learn about them either if the debtor reveals their existence or if the holder of such interest and right decides to assert them. The option of making only a general rather than a specific declaration relating to non-registrable non-consensual rights and interests adds to the uncertainty which the creditor may experience when attempting to establish what interests encumber the object. However, the fact that a Contracting State is given an opportunity to make such a declaration has its benefits. By searching the registry and finding that a declaration (even a general one) exists, the creditor is put on notice that certain non-consensual rights and interests may take priority over its own registered interest.<sup>187</sup> It is then up to the creditor to clarify who the holders of these rights and interests may be and, possibly, pay for the debts owed by the debtor to them in an attempt to preserve priority of its registered interest. If nothing is done, the holder of non-consensual right may be able not only to detain,

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<sup>183</sup> *Channel Airways Ltd v The Lord Mayor, Aldermen and Citizens of the City of Manchester* [1974] 1 Lloyd’s Rep 456.

<sup>184</sup> *Ibid* 461. However, on the facts, it was held that the corporation agreed not to exercise its right and for this reason detention could not be justified.

<sup>185</sup> *Bristol Airport Plc and Another v Powdrill and Others* [1990] Ch 744.

<sup>186</sup> *Ibid* 760.

<sup>187</sup> G Mauri ‘The Cape Town Convention on Interests in Mobile Equipment as Applied to Aircraft: Are Lenders Better Off Under the Geneva Convention?’ (2005) ERPL 641, 646.

but also to sell the aircraft.<sup>188</sup> Once the aircraft is sold and all non-consensual rights (and possible other interests which were registered prior to the interest of the creditor) are satisfied, little may be left for the creditor. Another advantage of the existence of the option to make a declaration is that the creditor may be certain that only those non-consensual rights and interests which are listed there may present a threat to the priority of its registered interest.<sup>189</sup> Once all possible holders and nature of such interests are identified, the creditor may be certain that other non-registrable non-consensual rights and interests will not be able to shift its position in the queue of registered creditors.<sup>190</sup>

Secondly, a Contracting State can also protect rights of arrest or detention of aircraft objects which do not directly arise under its national law, but flow from a contract.<sup>191</sup> By making Article 39(1)(b) declaration, a Contracting State may preserve rights of arrest and detention of the object which can be exercised by a private provider of public services for debts related to those services in respect to that particular or other aircraft object.<sup>192</sup> Even though the right of arrest or detention flows from a contract, it must arise under domestic law of a declaring State. One case may illustrate how a contractual right of detention may arise. In this case, a contract between a provider of aircraft maintenance services and an aircraft operator stated that the former had ‘a general lien on all goods in its possession for all sums owed at any time by the company and shall be entitled to sell...such goods...and apply the proceeds towards the payment...’.<sup>193</sup> The repairer refused to deliver up an aircraft to the receivers because the aircraft operator did not pay for repair and maintenance work performed by it. It was held that while the contractual right of detention was valid, it could not have been exercised without the leave of the court.<sup>194</sup>

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<sup>188</sup> *International Nederlanden Aviation Lease BV & Ors v The Civil Aviation Authority & Anor* [1997] CLC 43.

<sup>189</sup> Mauri (n 187) 646.

<sup>190</sup> *Ibid* 646.

<sup>191</sup> Art 39(1)(b).

<sup>192</sup> Goode (n 11) 257.

<sup>193</sup> *London Flight Centre (Stansted) Limited Acting by its Administrator v Osprey Aviation Limited* 2002 WL 1310827.

<sup>194</sup> In similar vein, some commentators suggest that the Belgian right of retention granted by domestic law for maintenance and repair works of aircraft should be covered by a declaration under Art 39. See G Mauri and B V Itterbeek, ‘The Cape Town Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific to Aircraft Equipment: a Belgian Perspective’ (2004) 9 *Unif L Rev* 547, 554.

The declaration under Article 39(1)(b) is drafted in terms which are wide enough to cover charges collected by EUROCONTROL in its own name, but the declaration itself must be made by a Contracting State and not by a private organisation.<sup>195</sup> EUROCONTROL is an international organisation providing air navigation facilities and coordinating the provision of such services by national providers.<sup>196</sup> EUROCONTROL collects route charges on behalf of some 30 Member States participating in the common Route Charges System. Representatives of Belgium, where EUROCONTROL is based, suggested that while an Article 39(1)(a) declaration adequately protects non-consensual rights and interests recognised in Contracting States, an Article 39(1)(b) declaration is needed in order to protect collecting of charges by EUROCONTROL. Failure to implement the declaration could result in reduction of recovery of route charges by this organisation which could be detrimental to the Member States.<sup>197</sup>

Finally, a non-consensual right or interest covered by an Article 39 declaration will, generally, have priority over a registered international interest only if the declaration was deposited prior to its registration.<sup>198</sup> This rule allows the creditor to search the registry in order to determine whether any non-consensual rights or interests can affect its priority before making a decision in relation to availability and cost of the credit. However, by way of exception, it is open for the Contracting State to declare that non-consensual rights and interests covered by Article 39(1)(a) may have priority over international interests which had been registered before the declaration was made.<sup>199</sup> This means that the priority of the creditor, who provided a loan to the debtor after the search did not reveal any Article 39 declarations, may still be postponed to non-consensual rights and interests if the declaration is submitted at a later stage. Accordingly, the creditor may still need to conduct searches in the registry in order to reveal whether any such declarations have been made after its interest was registered.

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<sup>195</sup> Goode (n 11) 258.

<sup>196</sup> For example, the Civil Aviation Authority which was established by the Civil Navigation Act 1971 for regulating civil air transport in the UK. Charges relating to air navigation services could be paid to the CAA or EUROCONTROL and these organisations could, in some cases, have rights of detention and sale of an aircraft in case of default. See, for example, *Irish Aerospace (Belgium) N.V. v European Organisation for the Safety of Air Navigation and Civil Aviation Authority* [1992] 1 Lloyd's Rep 383.

<sup>197</sup> See proposal by Belgium in Diplomatic Conference (n 138) 242-243.

<sup>198</sup> Art 39(3).

<sup>199</sup> Art 39(4).

## b) Assignments and prospective assignments of international interests

Assignments<sup>200</sup> and prospective assignments of international interests can be registered in the International Registry under Article 16(1)(b). The Convention only governs contractual assignments conferring on the assignee associated rights with or without the related international interest.<sup>201</sup> A prospective assignment relates to an assignment which is intended to be made in the future on the occurrence of a stated event irrespective of whether the occurrence of this event is certain.<sup>202</sup> Assignment can only be made by a creditor, i.e. either by the chargee, conditional seller or the lessor.<sup>203</sup> The creditor may decide to assign its interest in the object held by the debtor if, for example, it needs funding and approaches its own creditor in order to obtain a loan. If asked to provide a security for the repayment of the loan, the creditor may assign its interest in the object held by its debtor. Once the creditor's debt to the assignee is discharged, its interest in the object will be returned to it.

Assignment can be made outright or by way of security.<sup>204</sup> In an outright assignment, the lessor of the aircraft object can register its international interest and later assign its rights under the leasing agreement to the assignee. As a result of the outright assignment, the assignee will receive not only the associated rights (for example, rights to rental payments under the lease), but also the international interest of the lessor. Once the assignee is registered as the holder of the assigned international interest, it will be able to assert the same priority status as the original lessor and to obtain rental payments from the debtor (lessee). If the assignment was only by way of security and the lessor discharges its debt to the assignee, the interest of the latter is effectively extinguished and the right to remaining rental payments under the lease reverts to the lessor.<sup>205</sup>

Associated rights mean all rights to payment or other performance by the debtor under the agreement. For example, rights to repayment of a loan under a

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<sup>200</sup> On assignments generally and contractual prohibitions against them see R Goode, 'Contractual Prohibitions against Assignments' [2009] LMCLQ 300.

<sup>201</sup> Art 1 (b).

<sup>202</sup> Art 1(x).

<sup>203</sup> For this reason, an assignment by a lessee (unless it is entitled to sub-lease and act as a lessor) will not be governed by the Convention. See Goode (n 11) 235.

<sup>204</sup> Art 1(b).

<sup>205</sup> Goode, Illustrations 29, 30 (n 11) 241.

security agreement, payment of the price under conditional sale agreement as well as other forms of performance, such as insurance of the object will be treated as associated rights under the Convention.<sup>206</sup> Associated rights are said to be secured by the security agreement and associated with the retention of title or a lease agreement.<sup>207</sup>

Since Article 16(1)(b) renders assignment and a prospective assignment separate categories of registrable interests, it follows that they can be registered even if the international interest to which these interests relate is not itself registered.<sup>208</sup> But the priority of a registered assignee is of limited scope under the Convention. The registration of an assignment of the unregistered international interest will help the assignee to defeat the interests of subsequently registered and unregistered assignees.<sup>209</sup> But it will be subordinated to the holder of a subsequent international interest who registers its interest first as well as to assignees of such registered holder.<sup>210</sup> Finally and unless the parties agree otherwise, the assignment of associated rights transfers to the assignee the related international interest and the priority status of the assignor, but if the international interest itself is not valid, its assignment will also be ineffective.<sup>211</sup>

c) Acquisitions of international interests by legal or contractual subrogation under the applicable law

Sub-paragraph (c) makes acquisitions of international interests by legal or contractual subrogation arising under the applicable law a registrable interest and this is considered to include subrogation under Article 9(4) of the Convention itself.<sup>212</sup> The applicable law is generally treated in the Convention as a law different from the Convention itself. However, in this particular instance, it can be argued that the right of subrogation under Article 9(4) can be treated as the right given by the applicable law of the Contracting State.<sup>213</sup> Article 9(4) provides that where after default by the debtor and before the charged object is sold, the full

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<sup>206</sup> Goode (n 11) 155.

<sup>207</sup> Art 1(c).

<sup>208</sup> Goode (n 11) 79.

<sup>209</sup> Goode (n 11) 237.

<sup>210</sup> Ibid 237.

<sup>211</sup> Ibid 237.

<sup>212</sup> Ibid 196.

<sup>213</sup> Goode (n 9) 185.

payment of the amount secured is made by an interested person other than the debtor, that person is subrogated to the rights of the chargee.<sup>214</sup>

#### d) Notices of national interests

The Convention does not define mobility of objects or international character of the transactions governed by it. The main reason for this is because these features were considered to be inherent in the nature and intended use of the equipment. This may lead to situations where a purely internal transaction, in that all concerned parties as well as equipment are located in the same Contracting State, may be covered by the Convention. While this possibility was not thought to be likely to occur with respect to aircraft and space objects, the situation may be different in relation to railway objects. For this reason, the Luxembourg Protocol provides that a security agreement, title reservation or a leasing agreement where the relevant railway rolling stock is only capable, in its normal course of use, of being operated on a single railway system within the Contracting State because of track gauge or other elements of the design, such a transaction shall be considered as an internal transaction.<sup>215</sup>

The Convention allows Contracting States to make a declaration under Article 50(1) excluding internal transactions from its ambit.<sup>216</sup> In order to be considered as an internal transaction, a security agreement, title reservation or a leasing agreement must be structured in such a way that a) the centre of all main interests of all parties to it and the object itself must be located in the same Contracting State at the time of the conclusion of the contract; b) the interest created by the transaction is registered in a national registry of that Contracting State and c) the Contracting State has made the declaration under Article 50(1).<sup>217</sup> An interest created by the internal transaction and held by the creditor in the object covered by the declaration is defined as a national interest by the

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<sup>214</sup> For the right of subrogation arising under English law see, for example, *Banque Financiere de la Cite v Parc (Battersea) Ltd* [1998] 1 All ER 737; *Boscawen v Bajwa* [1995] 4 All ER 769.

<sup>215</sup> Art XXIX(2).

<sup>216</sup> As of December 2009, only China and Mexico have made Art 50 declarations. See: <<http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/article50.htm>>.

<sup>217</sup> Art 1(n).



Convention.<sup>218</sup> While the national interest itself cannot be registered in the International Registry, it is possible to register a notice stating that the national interest was created.<sup>219</sup> The declaration under Article 50(1) has a limited effect in that the basic provisions of the Convention on registration and priority will still apply to such notices.<sup>220</sup> Once the notice of national interest is registered in the International Registry, it is protected against subsequently registered and unregistered interests.<sup>221</sup> Similar to other registrable interests under the Convention, failure to register a notice of the national interest will result in the loss of priority to a registered interest.<sup>222</sup> At the same time, the provisions of the Convention dealing with default remedies will not, generally, apply to notices of national interests.<sup>223</sup>

The major practical problem with internal transactions is that they can be turned into an international transaction overnight if, for example, the object is moved to another jurisdiction and the creditor will not always have the means to learn about this change in time.<sup>224</sup> One question which may arise at this point is what happens with the status of the registered notice of the national interest. On one view it may be argued that, since the purpose of Article 50 declaration and the general meaning of internal transaction as defined by the Convention, is to exclude from its ambit transactions where all relevant parties and the object are located in the same Contracting State, once the object is moved to a different jurisdiction, the nature of the transaction is no longer internal.<sup>225</sup> This means that the transaction is no longer covered by the declaration and the registration of the notice of national interest is not effective. The interest of the creditor will, for this reason, be unprotected and the only solution may be to register the same interest as an international interest in the registry. Although this may help the creditor protecting its interest against subsequently registered and unregistered interests, its previous priority status will be lost. Alternatively, it may be argued that provision of Article 1(n) in relation to the time of the conclusion of the contract

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<sup>218</sup> Art 1(r).

<sup>219</sup> Art 1(t).

<sup>220</sup> Goode (n 11) 275.

<sup>221</sup> Ibid 275.

<sup>222</sup> Art 29(1).

<sup>223</sup> Art 50(2) states that only Art 8(4) and 9(1) dealing with default remedies can apply to internal transactions. See also Mauri (n 187) 651.

<sup>224</sup> Mauri (n 187) 651.

<sup>225</sup> Goode (n 11) 275.

may help preserving the status of the internal transaction. Article 1(n) states that all the requisites of the internal transaction (i.e. a) all parties and the object should be located in the same Contracting State, b) the interest must be registered in the national registry, c) the Contracting State has made Article 50 declaration) must be present at the time of the conclusion of the contract. Accordingly, once all the requirements of Article 1(n) are met at the time of the conclusion of the contract, the transaction crystallises into the internal transaction and any later changes with respect to its constituent parts should not change its characterisation into an international transaction. This approach would rid the creditor of the necessity to monitor whether the object is still located in the same Contracting State and allow it to preserve its priority position. Although this view may be criticised if the object was clearly relocated to a different jurisdiction, stripping the transaction of its internal nature, it may bring more certainty for the parties. For example, what happens if the object was moved to another jurisdiction for a brief period of a week and then returned back to the Contracting State? On the first view, once the object is moved, the transaction is no longer internal and the registered notice of national interest is not effective. Consequently, the fact that the object is returned cannot resurrect the registered notice. But the creditor may not have even been aware that the collateral was moved for such a brief time. If, however, the second approach is preferred, once the transaction is characterised as an internal one and the notice of national interest is registered, the creditor may rest assured that its priority will be intact which will help reduce the risk associated with the repayment of the debt and reduce the cost of credit.

Another practical solution, which does not offer a clarification to the status of the registered notice of the national interest once the object is moved, but which may help the creditor avoid the loss of protection of its interest, is to refrain from registering it in the national registry. If the creditor does not register its interest in the national registry either because the registry for the objects in which the creditor has an interest simply does not exist in that Contracting State or for some other reason, the transaction will not be considered as internal for the purposes of the Convention. Consequently, there will be no need to register it as a notice of the national interest and it can be registered as an international interest. Such international interest will be considered as validly created and registered under the Convention even if the domestic law of the Contracting States makes

the registration in the national registry a precondition for the creation of the interest. Provided that the formal requirements of the Convention are met, the international interest will be validly created and can be registered in the International Registry.

e) Subordinations of interests referred to in any of the preceding sub-paragraphs

When a debtor needs a new loan in addition to the one that it has already taken, the creditor may be willing to provide it with the funds. The new loan may stimulate further investment by the debtor and help it repay the debt. But if the debtor's financial position is not strong, the creditor may decide that additional lending may increase the risk of non-repayment and decline the offer to extend more funds to the debtor. Instead, the creditor may be prepared to yield its priority to a subsequently registered or a new creditor willing to provide the debtor with a fresh advance.<sup>226</sup> By subordinating its priority to a subsequent creditor, the yielding creditor may improve its prospects of being repaid by the debtor.<sup>227</sup> The subordination agreement changing the priority positions of the creditors can be registered in the International Registry under Article 16(1)(e). The subordination agreement may relate to any of the registrable interests under the Convention. For example, a notice of a national interest which is registered first can be subordinated to a subsequently registered international interest and the subordination agreement to that effect may itself be registered in the International Registry. Article 29(5) reinforces the importance of the need to register the subordination agreement. This provision does not create a new registrable interest, but rather firstly, stipulates that the parties may vary the priority of their competing interests and secondly, states that an assignee of a subordinated interest will not be bound to yield that interest unless the subordination agreement was registered at the time of the assignment. For example, consider secured creditor 1 and secured creditor 2 who each register their interests in an aircraft engine in turn. Later, SC1 agrees to yield its security interest to SC2 who fails to register the subordination agreement. Should SC1 decide to assign its interest to A1, the latter will not be bound by the unregistered subordination agreement and will enjoy

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<sup>226</sup> Beale, Bridge, Gullifer, Lomnicka (n 68) 289.

<sup>227</sup> Ibid 289.

priority over SC2 even if it had actual knowledge of the agreement.<sup>228</sup> Otherwise, the assignee could wrongly assume that a senior priority position was transferred to it without the means of discovering the subordination agreement between its assignor and the other party.<sup>229</sup>

Finally, Article XVI of the Aircraft Protocol establishes a regime of quiet possession of the object by the debtor. In the absence of default, a debtor is entitled to quiet possession as against, for example, its creditor and any interest to which it would have been otherwise subordinated where the holder of that interest agrees to quiet possession.<sup>230</sup> At the same time, the debtor is not entitled to quiet possession as against the holder of any interest which is superior to the debtor's interest.<sup>231</sup> But the parties may vary this position and the agreement reflecting the subordination may be registered in the International Registry in order to bind third parties.<sup>232</sup> For example, a head lease may provide that any sub-lease will be subordinated to it. If the head lessor later agrees with the sub-lessee that the registered international interest of the former will be subject to the quiet possession of the latter and, provided that the subordination agreement to that effect is registered, the subordination agreement will bind any third parties. So, if a secured creditor of the defaulting head lessor later attempts to exercise its remedies against it, it will be bound by the registered subordination agreement allowing the sub-lessee to enjoy quiet possession of the aircraft object.

#### 4. The process of registration

##### 4.1 Formal requirements for registration

###### 4.1.1 General

Once an international interest comes into existence, the creditor obtains a proprietary interest in the object held by the debtor. Although the newly created international interest is a right in rem, it is not visible to third parties and for this

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<sup>228</sup> Goode (n 11) Illustration 24, 230.

<sup>229</sup> Ibid 227.

<sup>230</sup> Art XVI (1) of Aircraft Protocol.

<sup>231</sup> Goode (n 11) 336-337.

<sup>232</sup> Ibid 337.

reason may not necessarily be binding on them. In order to be enforceable against third parties, such as other creditors and persons in charge of liquidation or administration of the debtor company, the international interest (or another type of registrable interest) should be registered in the International Registry.<sup>233</sup> Since registration serves as a notice of possible existence of the international interest and allows the creditor to secure its priority, the latter has a strong incentive to register the newly created or a prospective interest as soon as possible. For this reason, effecting a registration in the International Registry is not mandatory and the creditor will only register its interest if it decides to take advantage of its benefits.<sup>234</sup> The Convention does not prescribe a time period during which the interest should be registered in order to be enforceable against third parties: since the creditor is aware of the fact that any delay in registration may cause a loss of priority, it will strive to register its interest as quickly as possible.<sup>235</sup>

#### 4.1.2 The identity and electronic signature of registering party

Formal requirements for effecting a registration and for making searches are for the most part simple. The Convention itself does not stipulate what information should be transmitted to the Registrar and delegates this issue to the relevant Protocols, Regulations and Procedures. The information required to effect a registration of an interest includes the identity and electronic signature of the

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<sup>233</sup> This process is also known as perfection in some registration systems. There may be different modes of perfection depending on the type of the object and nature of the security interest. For example, Article 9 UCC recognises four types of perfection, namely, automatic perfection, control of intangibles, possession of goods and registration or filing. Filing of a financing statement is considered to be the most important of these modes. See White and Summers (n 74) 757; McCormack, 'Reforming the Law of Security Interests: National and International Perspectives' (2003) *Singapore J Legal Studies* 1, 14. For a discussion of control as a mode of perfection under the UCC see M Springer, 'Perfecting a Security Statement in 'Electronic Chattel Paper' under Revised Article' (2001) 31 *U Memphis L Rev* 491.

<sup>234</sup> English law, which does not, generally, tie priority of interests to the time of their registration, takes a different approach. S. 861(5) Companies Act 2006 (replacing s. 396(4) Companies Act 1985) stipulates that the prescribed particulars together with the instrument creating or evidencing the creation of a registrable charge should be delivered to the registrar within 21 days of creation. Failing that, the charge will be void against any creditor, administrator or a liquidator of the debtor. See McCormack (n 69) 167. For an alternative view, suggesting that registration in the International Registry should be made mandatory see N Backovic, 'Securing the Security Agreements - A Possible Amendment to the Cape Town Convention through its Protocols' (2007) *Unif L Rev* 715.

<sup>235</sup> The Registrar will ensure that the registration information is entered into the International Registry data base and is made searchable in chronological order of receipt. The file of registration will also record the date and time of receipt. See Art 18(4), the Convention.

registrant and the statement on whose behalf that person is acting as well as the identity of the named parties.<sup>236</sup> The identity means the name, address and electronic address of the registrant or of those parties in respect of whom the identification information is sought.<sup>237</sup> If the creditor is an international organisation such as a bank with offices in several states, the question may arise as to which of these offices should be indicated as the relevant address. The Regulations do not govern this issue, but even if the address given by the registering party is not that of its head office, this should not present a major problem. The information in the registration is only intended to provide a searching party with a basic notice of possible existence of the interest held by a certain creditor. The information in relation to the name, one of the addresses and an email address should be enough to enable a searching party to find the creditor and to clarify the details of its registered interest.

The registrant must also provide its electronic signature irrespective of whether the registering party is a creditor itself or a person acting on its behalf.<sup>238</sup> The purpose of this requirement is not entirely clear. It may be argued that the electronic signature can provide assurance to the Registrar that the information transmitted to it is complete and accurate and that parties agree with its content. But the Registrar has no means to establish whether the signature is authentic and was inscribed by the relevant party.<sup>239</sup> Furthermore, the registration information must only be supported by the signature of a registering party. Since the creditor will have a stronger incentive to register its interest in the object than the debtor, the registering party is likely to be the creditor or its representative and not the debtor. This means that the debtor's acceptance of the creditor's registered interest

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<sup>236</sup> S 5.3 (a), (b), the Regulations.

<sup>237</sup> S 2.1.6, the Regulations.

<sup>238</sup> In contrast, Article 9 UCC does not require a financing statement, its amendment or termination to be signed as long as it was authorised by the debtor. A security agreement usually amounts to sufficient authorisation. See E Ireland, 'Financing Statements under Revised Article 9' (2001) Wisconsin Law 14.

<sup>239</sup> For example, requirement of signature in financing statements was removed in Revised Article 9 as unnecessary. S. 9-502(a) of Article 9 UCC merely states that financing statement must provide 1) the name of the debtor, 2) the name of the secured party or its representative and 3) indicate the collateral covered by the financing statement. S. 9-516(b) Article 9 contains additional requirements which must be met in order for the financing statement to be accepted by the filing officer, but they too do not require either the debtor or the creditor to provide a signature. Instead, the financing statement must be authorised by the debtor and conclusion of a security agreement is sufficient for this purpose. See C Boss, 'A Trap for the Unwary: Revised UCC Art 9's Deceptive Technical Guillotine for Financing Statements' (2001) Consumer Fin L Quarterly Report 152; J Moringiello, 'Revised Article 9, Liens from the Fringe, and Why Sometimes Signatures don't Matter' (2001) 10 Widener J Pub L 135.

in the object will not be verified by the signature of the former. If the signature of the person whose interest in the object is being encumbered is not required, it is not clear why the Regulations require the party benefiting from the registration to transmit its signature.

The requirement of electronic signature may also be unnecessary because of strong control mechanisms in-built into the fabric of the Convention designed to ensure that the transmitted information is accurate and complete. First, the information in relation to a registration, its amendment or extension will not be entered into the data base of the International Registry so as to be searchable unless such actions are supported by a prior written consent by the other party, i.e. the debtor, communicated to the Registrar.<sup>240</sup> If the electronic consent of the party (other than a registering party) is not received by the Registrar within 36 hours from the transmission of the information, the registration will be aborted and will have no effect under the Convention.<sup>241</sup> The consent of the debtor, in this case, serves the function of a signature because it communicates to the Registrar the debtor's acceptance that the information transmitted to it by the creditor is correct. In other words, the purpose of the consent is to let the Registrar know that the debtor agrees to allow the registration of the creditor's interest in the object. Next, once the information is registered, the Registrar is required to send a prompt electronic confirmation to this effect to all relevant parties including the registering party, the debtor and other registered parties holding various interests in the same aircraft object.<sup>242</sup> The confirmation sent by the Registrar serves three purposes. It allows the registering party to make a final check that the information in the registration is correct. If the registering party finds that the registration contains mistakes and, for instance, states that its interest as a registered lessor will last for 5 instead of 7 years as intended by the parties to the leasing agreement, the registering party can make appropriate amendments to the existing registration. The confirmation also provides the debtor with the opportunity to object to the registration if the information contained in it is not correct and, for example, instead of registering a creditor's interest in an airframe held by the debtor, stipulates that the creditor also holds a registered interest in the aircraft

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<sup>240</sup> Art 20(1).

<sup>241</sup> Sec 12.2(b) of the Procedures.

<sup>242</sup> S 6.2, 6.3, the Regulations.

engine attached to it. Thirdly, since the confirmation is sent to all other holders of registered interests in the object, it relieves the prior registered creditor from the necessity to monitor whether the debtor subjected the aircraft object in which it holds interest to further encumbrances.<sup>243</sup>

Given that the registration merely provides a notice of possible existence of a registered interest and a searching party should contact the holder of such interest for further information, it is not clear why the information transmitted to the Registrar must include an electronic signature. It may be argued that this requirement can be easily met by simply typing the registering party's name at the space allocated for the signature. But the Regulations and Procedures do not provide a definition of an electronic signature and in some instances refer to it not simply as an electronic, but as a digital one. For example, s 12.2 of the Procedures states that once the registering party has entered registration information and digitally signed it, each named party shall be notified about it by electronic mail. This may mean that the registering party has to purchase a unique digital signature consisting of private and public keys which may render the process of effecting a registration costly and time consuming. This outcome could have been avoided if no electronic signature had been required for the purposes of transmitting the information to the Registrar.

#### 4.1.3 Identification of the object and errors in the registration data

Registrations and searches in the International Registry must be effected against a uniquely identifiable object and not against the debtor's name. This means that transmission of correct information identifying the object is vital in order to allow a searching party to locate the relevant registration and any extensions, amendments or discharges relating to it. A simple mistake as to a serial number of the object or the model designation may mean that the searching party will not be able to locate the registration and may be misled by a clear search into assuming that its interest will be the first to be registered in the system.<sup>244</sup> In order to reduce

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<sup>243</sup> Holders of other interests are free to electronically elect not to receive such confirmation from the Registrar. Such elections must be supported by a digital signature. See S 6.5 of the Regulations.

<sup>244</sup> The result would be different in debtor-based registration systems which do not usually require unique identification of the object. For example, in an English case *Cunard Steamship Company*,



the possibility of mistakes, the International Registry limits transmission of free text identifying the aircraft object.<sup>245</sup> Instead, the registering party must select the relevant data from the drop-down menu wherever provided by the registration system.<sup>246</sup>

The registering party must indicate i) the type of aircraft object, i.e. whether it is an airframe, an aircraft engine or a helicopter, ii) manufacturer's name, iii) manufacturer's generic model designation and iv) the serial number assigned to the aircraft object by the manufacturer.<sup>247</sup> The same information should be sufficient in order to conduct a search of any registered interests in the aircraft object.<sup>248</sup> The information regarding the manufacturer serial number (MSN) can be entered as a free text into the search application form. Once the serial number is entered, the searching party is invited to select the name of the manufacturer from the list provided in the form. If, for example, MSN 3000 and Airbus as the name of the manufacturer are selected, the system will then list types of model designations used by this particular manufacturer. The model designations relate to different families of aircrafts produced by the manufacturer and the searching party may select, for example, an A320 model from the menu, rather than type it in as a free text.<sup>249</sup>

Although the possibility of mistakes in registration data is reduced by limiting the use of free text where appropriate, errors may still occur. The Convention does not explain the legal consequences flowing from such mistakes,

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Limited v Hopwood [1908] 2 Ch 564 it was held that where one ship was substituted for another, new registration of security was not required because prescribed particulars only asked for a general description of the object.

<sup>245</sup> S 5.1 of the Regulations.

<sup>246</sup> Identification of railway objects for the purposes of registration is more complex. Since no universal system providing unique identification of railway objects exists in the industry, the simple approach taken by the Aircraft Protocol could not be adopted under the Luxembourg Protocol. The issue of unique identification will be governed by the Regulations and the Protocol merely states that the identification number shall be either a) affixed to the object; b) associated in the International Registry with the manufacturer's name and identification number or c) associated in the International Registry with a national or regional identification number. Since the railway registry is not yet in operation it is difficult to predict how the issue of identification will be resolved. See Art XIV(1) of the Luxembourg Protocol.

<sup>247</sup> S 5.3(c) of the Regulations.

<sup>248</sup> In the case of an airframe or a helicopter, the search can also be conducted against the State of registry of the aircraft of which it is part or against the nationality or a registration mark if this information is available. See s 7.1 of the Regulations.

<sup>249</sup> If the registration relates to an airframe or a helicopter, it is also possible to enter the information regarding the current or intended State of Registry for nationality purposes and the current or intended aircraft nationality and registration marks assigned pursuant to the Convention on International Civil Aviation 1944 (Chicago Convention). S 5.3(d) of the Regulations.

namely whether the registration may be treated as effective or should be invalidated altogether. It is submitted that although the Convention does not expressly deal with this issue, the effect of mistakes on the validity of registration should still be governed by it. This should be the case because this issue relates directly to the functioning of the International Registry and the effect of registrations recorded in it. The International Registry is the creation of the Convention and, for this reason this issue should be governed solely by it and not by the applicable law. Since the Convention does not expressly deal with the consequences of mistakes in registration data, this matter should be settled in conformity with general principles on which it is based.<sup>250</sup>

On the one hand, it may be argued that such principles as predictability and transparency underpinning the Convention suggest that any error in the registration data however slight should lead to invalidation of the registration. If the searching party knows that any mistake in the transmitted information will render the registration invalid, it may safely rely on the search result even if it is clear and no registration can be found against the aircraft object. Should it later transpire that there in fact existed a previous registration in relation to the same aircraft object, but this registration could not have been located because of a simple mistake as to the model designation of the airframe, the principle of predictability would seem to dictate that the mistaken registration should not bind the searching party. The application of the principle of transparency would seem to lead to the same result. This principle operates through the rules of the registration of international interests in order to give third parties notice of their possible existence and subordinate unregistered interests to registered ones.<sup>251</sup> The registration renders the international interest visible to the searching party. Consequently, if the interest cannot be seen in the International Registry as a result of mistakes contained in the registration information relating to it, such registration should not be binding on the searching party.

On the other hand, it may be suggested that invalidation of a registration due to any mistake however insignificant may be a step too far. Since human intervention cannot be avoided when the registration information is entered for the purpose of transmission to the Registrar, the possibility of mistakes will always

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<sup>250</sup> Art 5(2).

<sup>251</sup> Goode (n 11) 18.

exist.<sup>252</sup> Holding that mistakes in the data will necessarily invalidate the registration may be too harsh and commercially impracticable: creditors may decide that if the effect of any mistake is a loss of priority, the price of effecting a registration is too high. As a result the creditor may decline to provide a loan or to increase the cost of credit to such an extent that it may no longer be afforded by the debtor. This approach may lead to decreased use of the International Registry which may hinder promotion of one of the main objectives of the Convention, namely facilitation of asset-based financing and leasing of mobile equipment. For this reason it is submitted that mistakes in the information transmitted to the Registrar should not necessarily invalidate the registration and a more flexible solution can be found within the Convention. First, the Convention provides that the registration information may be amended if required.<sup>253</sup> This means that if, for example, after the registration information is submitted to the Registrar and a confirmation of such registration is received, a registering party notices a mistake in the data, it has an opportunity to make an amendment to the initial registration to cure this defect. The fact that the Regulations expressly allow amendments of registration information should necessarily mean that mistakes in the data should not lead to automatic invalidation of the registered interest and that the amended registration may still be effective. Secondly, whether erroneous data will render the registration ineffective should arguably depend on the gravity of the mistake.<sup>254</sup> For example, if the mistake relates to the duration of the registration, which states that it will last for 5 instead of 7 years, this information can be easily amended. Such a mistake will not prevent the searching party from discovering that the registered interest exists in the aircraft object and will allow it to approach the named registering party for further information. The suggestion that this type of mistake should not invalidate the registration can be supported by the approach taken by the Regulations to priority of amended registrations. The Regulations draw a distinction between those amendments which can be rendered without prejudice to the priority of the registering party and those amendments which may shift the priority status of the creditor. If the amendment relates to duration of the registration, the registering party will retain the same priority position as it had at

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<sup>252</sup> Goode (n 11) 54.

<sup>253</sup> Art 16(3) states that the term 'registration' includes, where appropriate, an amendment, extension or discharge of registration.

<sup>254</sup> Goode (n 11) 54.

the time of the original registration.<sup>255</sup> This must mean that the amended registration is effective and binding on the searching party. This result accords with one of the main objectives of the registration system, namely to provide a notice of possible existence of registered interests in the object. If the information, albeit erroneous, allows the searching party to discover the registered interest and approach the registering party for more details, the mistakes contained in the data should not invalidate the registration. On the other hand, if erroneous data relates to the identification of the object, the situation may be different. This information is of vital importance to the searching party because it allows it to determine whether the aircraft object is encumbered by any previously registered interests. Consequently, if the registering party mistakenly enters an incorrect manufacturer's serial number or a model designation, this may mean that the searching party will not be able to find this registration. This will be the case because the information identifying the aircraft object is the only criterion allowing the searching party to locate any prior registrations. A mistake as to a serial number or the name of the manufacturer will probably mean that the registering party will appear to have an interest in another object which will not be visible to the searching party. It is submitted that such registration should be of no effect and should not be binding on the searching party. It is possible to register an amendment rectifying the mistake as to the identification of the object. But the original priority position of the registering party will be lost. The amended registration will be treated as a new registration and its priority will rank from the time when the amending registration is complete.<sup>256</sup>

To summarise, the approach of the Regulations seems to support the view that if mistake relates to the information which helps the searching party to locate any registrations relating to the particular aircraft object, it may have the effect of invalidating the registration. The only option open to the registering party in this case is to make a new registration. If the mistake is discovered and amended soon after the initial registration is effected, the priority position of the registering party may not have greatly deteriorated. In contrast, if the mistake relates to the information which may not prevent the searching party from discovering the registered interest, such a mistake should not invalidate the registration.

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<sup>255</sup> S 5.11(d) of the Regulations.

<sup>256</sup> Sec 5.11(a) of the Regulations.

The approach of the Convention and the Regulations may be contrasted with the position under Article 9 UCC where registrations of filings are made against the debtor's name, and not against the object. Since the debtor's name is the only criterion enabling a searching party to find out about security interests of the debtor's creditors, a misspelled or an incorrect name may mean that the searching party would not be able to locate financing statement of the filing party.<sup>257</sup> The Revised Article 9 deals with the issue of whether such a mistake invalidates the financing statement of the creditor and causes loss of priority by introducing a new standard logic test.<sup>258</sup> Electronic filing systems operate in such a way that once the search is ordered, the searching party is presented with a list of several similar names one of which could be the name of the debtor. This enables the searcher to locate the correct name of the debtor and to find out which creditors claim to have security interests in its property. This means that even if the filing creditor mistakenly misspells the name of the debtor, but the mistake is a minor one and if the filing system in question is flexible enough to include the misspelled name into the list presented to the searcher, the latter may still be able to recognise the name of the debtor and to make the relevant enquiries from the filing creditor. This is essentially what the standard search logic is about: if the searcher, when typing in the correct name of the debtor, is able to locate this name in its mistaken variation, then the financing statement containing the mistake will be valid and the filing creditor will retain its priority.<sup>259</sup> The main difficulty with this test is that although it allows the filing creditor a possibility that the financing statement containing a mistake as to the debtor's name will still be effective, the outcome of each case depends on how flexible the filing system is at any

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<sup>257</sup> For a discussion of different approaches taken by the US courts in an attempt to clarify whether a mistake as to the name of the debtor invalidates the financing statement see M Livingston, 'A Rose by any other Name Would Smell as Sweet (or Would It?): Filing and Searching in Article 9's Public Records' (2007) *Brigham Young U L Rev* 111. See also J Morris, 'The Fruits of Mischievous Seeds: Notice Filing under Article 9 and the Continuing Problem of Trade Names' (1986) *11 U Dayton L Rev* 241; R Corbi, 'The Harshness of the 'Seriously Misleading' Rule in Financing Statements' (2008) *Am Bankr Inst J* 24.

<sup>258</sup> For the explanation of this test and problems associated with it see L LoPucki, 'The Spearheading Tool Filing System Disaster' (2007) *68 Ohio State L J* 281; M Livingston, 'Survey of Cases Decided under Revised Article 9: There's Not Much New under the Sun' (2003) *2 DePaul Bus Comm L J* 47.

<sup>259</sup> M Sercombe, 'Good Technology and Bad Law: How Computerization Threatens Notice Filing under Revised Article 9' (2006) *84 Tex L Rev* 1065 in which the author suggests that because the new test depends on the flexibility of individual search systems in various filing offices, the test does not allow the filing system to perform its function of providing notice to third parties. Instead, it is used as a tool for invalidation of perfected financing statement by trustees in bankruptcy.

particular filing office. In many cases, the system does not tolerate even the slightest mistakes, when, for example, only one wrong letter is used, which may lead to the conclusion that, in practice, no mistakes are allowed at all. The outcome may be different under more flexible Canadian filing systems which are also mainly debtor-based. Recognising that having only one searching criterion may put unnecessary pressure on the filing creditor and realising that mistakes cannot always be avoided, the system allows the use of an alternative searching criterion in relation to such types of collateral as aircrafts and ships.<sup>260</sup> Since these objects usually have unique serial numbers, the filing system allows the searcher to use either the name of the debtor or the serial number of the object in order to find out whether it is encumbered by previous security interests.

The Convention does not provide any test for deciding whether the mistake relating to the identification of the object will invariably invalidate the international interest. Nor does the Convention provide for an alternative search criterion. Instead the Regulations simply state that any amendment in relation to the information identifying the object will be treated as a new registration and the new priority status will be fixed at the date of fresh registration. This may suggest that any mistake as to the identification of the object will lead to the invalidation of the international interest and the registering party's only option will be to effect a new registration. But what happens if the registering party does not amend the mistaken registration and the searcher can still locate it when it is presented with a list of search results? It is suggested that the searcher should be able to rely on the search certificate and if the results are clear, it should not be expected to check other objects in order to clarify whether a registering party has made a mistake. Since the registering party is in the stronger position to enter the correct information, the burden of the consequences of a mistake is better placed on it, rather than on the searching party.

#### 4.1.4 Other formal requirements

The Regulations also contain formal requirements which are specific to particular types of registrable interests. In cases of international and prospective

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<sup>260</sup> Cuming (n 61) 981-982.

international interests, a notice of a national interest or a registrable non-consensual right or interest a registering party may indicate the duration of the registration, if the registration is to lapse prior to the filing of a discharge.<sup>261</sup> The duration of the registration may also be indicated in the case of registration of a prospective sale, but not in the case of the registration of a contract of sale of an aircraft object.<sup>262</sup> In contrast, the duration of the registration need not be mentioned if the interests to be registered are such as an assignment or a prospective assignment of an international interest, the assignment of a registrable non-consensual interest or an international interest acquired as a result of subrogation.

Duration of registration determines the period during which it remains effective.<sup>263</sup> The Convention does not prescribe a specific time limit during which the registration remains current<sup>264</sup> and the parties are free to agree on a particular period of, for example, 5 or 20 years. Similar to the Convention, the Canadian Personal Property Security Acts allow the registering party to select a period of the duration of the registration ranging from 5 and 25 years to infinity.<sup>265</sup> The approach taken by the Convention has a strong commercial orientation. It allows the parties to select the period of duration which is closely tailored to their agreement without the need to monitor whether the registration needs to be extended to protect the same interest. If the security interest is to last for 7 years, the registering party can state that the registration of its interest as a secured creditor will be current for the same period. Had the Convention prescribed that the registration is only to last for 3 or 5 years, the creditor would have to revisit the International Registry before the registration expires and register an amendment extending the registration for the remaining period. The flexible approach taken by the Convention does not mean that the registered interest of the secured creditor will continue for the whole period of duration of the registration if the debtor repays the loan before this date. Once the secured obligations are performed, the registration will simply be automatically discharged. The Convention also permits extending the time of the duration of registration. But to

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<sup>261</sup> S 5.3(e) of the Regulations.

<sup>262</sup> S 5.4(c) of the Regulations.

<sup>263</sup> Registration may also be discontinued as a result of a discharge. See Art 21 of the Convention.

<sup>264</sup> Art 21.

<sup>265</sup> Cuming (n 61) 981.

do so effectively, the registering party, upon securing the necessary consent of the other party, must register an amendment extending the registration before the initial registration expires.<sup>266</sup> This will allow the registering party to preserve its priority status which will be fixed to the time of the original registration.<sup>267</sup> In contrast, once the registration expires, the option of extension can no longer be exercised and any new registration will attract a new priority position for the registering party.<sup>268</sup>

Other additional formalities which are specific to the type of the registered interest relate to assignments. For example, the Regulations prescribe that if the interest which is being assigned is a registered interest, the file number of the registration relating to that interest must also be indicated by the registering party.<sup>269</sup> If the interest which is being assigned is not a registered interest, the registering party must still describe the assigned interest and the debtor under that interest.<sup>270</sup> This allows the link between the original registered (and to some extent, unregistered) interest and the assignment of that interest to be visible to other parties. Consider secured creditor 1 who, after registering its interest in the International Registry, assigns it to A1. A1 also registers its interest and indicates the file number of SC1's interest. If the debtor grants another security interest in the same aircraft object to the secured creditor 2, who also registers and assigns its interest to A2, both SC2 and A2 will be able to discover the interest of A1 and assess their relative priority positions with better clarity before registering their interests in the object of the debtor.

Finally, any registration may specify that it covers a fractional or partial interest in an aircraft object held by the debtor and, if so, the extent of such interest.<sup>271</sup> The registering party can also register any increase or decrease to such interest which may arise as a result of a sale or an assignment. If the decrease in the registered interest occurs as a result of partial repayment of the secured debt, this change can also be reflected in the registration.<sup>272</sup>

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<sup>266</sup> Goode (n 11) 209.

<sup>267</sup> Ibid 209.

<sup>268</sup> Ibid 209.

<sup>269</sup> S 5.5(c).

<sup>270</sup> S 5.5(d) of the Regulations.

<sup>271</sup> Sec 5.14(a) of the Regulations.

<sup>272</sup> Sec 5.15 of the Regulations.



## 4.2 Validity and time of registration

### 4.2.1 Time of registration

Since priorities among competing creditors are determined by the order in which their interests are registered, the time of registration is of paramount importance to them. The registering party will want to know precisely at what moment its registration becomes effective so as to be binding on any subsequent creditors. There are different moments when the registration could be deemed to be effective: the registration could be effective once the registration information is transferred to the Registrar, when the Registrar confirms its receipt or when the data is entered into the registry. For example, under English law, the registrable charge has to be registered within 21 days from the time of its execution.<sup>273</sup> Once the registering party delivers the prescribed particulars and the instrument creating the charge to the Registrar, and provided that this is done within the prescribed period, the charge is treated as validly registered even if the information is not yet entered into the register.<sup>274</sup> Because the registering party has 21 days to deliver the documents and since the registration does not, generally, determine the order of priorities,<sup>275</sup> subsequent creditors searching the registry may be misled by a clear search. This may happen if a subsequent creditor searches the registry within the

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<sup>273</sup> This is subject to the possibility of extension of the time of registration which may be granted pursuant to a court order. In many cases, simple inadvertence on the part of the registering party may justify late registration. The late registration is usually allowed subject to a proviso that the order is issued without prejudice to the rights of parties acquired prior to the time of actual registration. See *In re Spiral Globe, Limited* [1902] 1 Ch 396; *In re Joplin Brewery Company Limited* [1902] 1 Ch 79; *Re Chantry House Developments plc* [1902] B.C.C. 646. *In re Ehrmann Brothers, Limited* [1906] 2 Ch 697. At the same time, if the winding up of the company commenced or if the liquidation is imminent, the order extending the time of registration is likely to be refused. See *In re Abrahams & Sons* [1902] 1 Ch 695; *Re Barrow Borough Transport Ltd* (1989) 5 B.C.C. 646; *In re Ashpurton Estates Ltd* [1983] Ch 110. It has been argued that the 21 day period, which can be extended to allow for a late registration, accentuates the ostensible ownership of the chargor and highlights the necessity of reform in this area of law. See I Davies, 'Floating Charges and Reform of Personal Property Legislation' (1988) Comp Law 47.

<sup>274</sup> Beale, Bridge, Gullifer, Lomnicka (n 68) 336.

<sup>275</sup> Since registration does not, generally, determine priority status, there is no incentive on the part of the registering party to effect the registration as quickly as possible. As long as this is done within 21 days of the creation of the charge, the registration should be valid. The position is different in relation to registration of aircraft mortgages whereby priority status depends on the time of registration. In addition, *Mortgaging of Aircraft Order 1972* allows for registration of a priority notice stating that a mortgage or a charge is to be granted over the aircraft. If such mortgage or charge is in fact registered in UK Mortgage Register within 14 days of the notice, the priority of such security interest will date back to the time of registration of the notice of priority. See P Thorne (n 113) 712.

21 day period, but before the registering party delivers the documents to the Registrar and assumes that no charge exists in relation to the object held by the debtor. If the registering party registers its charge within the prescribed period, the registration may still affect the subsequent creditor.

This result would not be satisfactory under the Convention, since the time of registration is essential for determining the order of priorities. If the subsequent creditor cannot rely on the search, it will not be able to clearly assess its priority position before deciding whether to provide a loan to the debtor. In order to ensure that the registration becomes effective as quickly as possible and to enable the searcher to make an informed decision based on its priority perspectives, the Convention stipulates that the registration shall be effective or complete upon entry of the required information into the International Registry data base so as to be searchable.<sup>276</sup> This means that even if the registering party has transmitted the necessary information and the Registrar has received it, the registration will not be effective until it is entered into the International Registry in such a way that it can be searched by any searching party. The registration becomes searchable once a) the International Registry has assigned to it a sequentially ordered file number and b) the registration information, including the file number, is stored in durable form and may be accessed at the International Registry.<sup>277</sup> Since the registry is electronically operated the time gap between transmission of the information and its entry into the system in a searchable form is likely to be short.<sup>278</sup>

#### 4.2.2 Valid registrations and grounds for invalidity

The interest registered in the International Registry will only survive the debtor's insolvency and provide its holder with priority if the registration of that interest was valid. In order to effect a valid registration or to amend, extend or discharge the existing one, the registering party must, of course, comply with the formal requirements set by the Convention, Regulations and Procedures. In addition to that, the registering party must also obtain an electronically transmitted consent of

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<sup>276</sup> Art 19(2).

<sup>277</sup> Art 19(3).

<sup>278</sup> Goode (n 11) 205.

the other party.<sup>279</sup> The requirement of prior consent provides an important safeguard against improper or incorrect registrations: if the registration was made without consent of the relevant party, it will not be effective.<sup>280</sup>

The text of the Regulations regarding the requirement of consent is somewhat confusing in that it is not entirely clear how many times consent must be provided before the registration can be treated as effective.<sup>281</sup> On one reading, it may seem that consent must only be transmitted to the Registrar once. S 12.2 begins by stating that '[e]ach named party, other than the registering party, required to consent...in order for a registration ...to become effective shall be electronically requested to consent thereto...prior to that registration becoming searchable.' S 12.2 continues to provide that '[o]nce a registering person has entered registration...information on the website...each named party...shall be given the opportunity to consent thereto, through the website, for a period of 36 hours.' The first sentence of S. 12.2 may be understood as a general reaffirming of the provisions of the Convention where the requirement of consent is initially spelled out. The reference to the period of 36 hours may then be read as a more detailed instruction on how to provide the consent in a timely manner. If this is correct, it means that consent must only be submitted once. It should be electronically transmitted to the Registrar prior to the registration becoming searchable and within the prescribed 36 hour period starting from the moment of request. On another reading, it may appear that consent has to be provided twice before the registration can become effective. First, a general consent must be provided and this should be accomplished prior to the registration becoming searchable, but not necessarily before the registration information is entered into the International Registry data base. Secondly, after the registration information is submitted to the data base, the other party has to send to the Registrar the second consent and it must be transmitted within the 36 hour period. Failure to send the consent within the prescribed period of time will result in the registration being automatically aborted.<sup>282</sup> It may be that while the first consent is of more general character, i.e. simply confirming that the other party is willing to grant a security interest in its uniquely identified aircraft object, the second consent is more

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<sup>279</sup> Art 18(1)(a) of the Convention and S 12.2 of the Regulations.

<sup>280</sup> Goode (n 11) 207.

<sup>281</sup> In this section the term registration includes an amendment, extension or a discharge.

<sup>282</sup> S 12.2 (b).

detailed stating that, for instance, the security interest is to last for 5 years and that it shall only cover a specific airframe but not the aircraft engines attached to it. S 12.3 seems to confirm that two consents are required by stating that '[u]pon receipt of the final consent, the Registrar shall automatically issue a confirmation thereof...'. The Regulations then appear to distinguish between the general or initial consent which must be transmitted prior to the registration becoming searchable and before the registration information is entered into the data base and the final consent which must be sent within the 36 hour period. If the second reading of S 12.2 is correct, this means that the registration becomes complete or valid when the Registrar receives the final consent of the other party and the registration becomes searchable and the confirmation to this effect is sent to all parties entitled to receive it.<sup>283</sup>

The unifying principle behind the requirement of consent is that it must be sought from the party whose interest in the object is likely to be affected by the proposed registration.<sup>284</sup> For example, in the case of a subordination of the international interest to another international interest, the subordination must be registered with the consent of the person whose interest has been subordinated.<sup>285</sup> Alternatively, the party whose interest is about to be subordinated or affected in some other way, can effect the registration itself. Similarly, an international interest, a prospective international interest or assignments of such interests may be registered by either party with the consent of the other.<sup>286</sup> In contrast, consent is not required in the case of registrable non-consensual right or interest and in the case of a notice of national interest which may only be registered by holders of such interests.<sup>287</sup>

The Convention does not explain what the effect of the registration is if it exceeds the consent given by the other party. Consider a security interest agreement whereby the debtor agrees to grant a security interest in a uniquely identified airframe to the secured creditor for the period of 7 years or until its present indebtedness of £5m is repaid. After the debtor transmits its consent to the Registrar, the secured creditor registers its international interest in the airframe to

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<sup>283</sup> S 12.3.

<sup>284</sup> Goode (n 11) 208.

<sup>285</sup> Art 20(2).

<sup>286</sup> Art 20(1).

<sup>287</sup> Art 20(5),(6).

secure the repayment of the present debt, but adds that any future indebtedness will also be secured by the same object. The question which may arise at this point is whether the registration will be, at least, partially effective or whether it will be invalidated altogether.<sup>288</sup> Since the consent in relation to the uniquely identified airframe and not another object (for example, an aircraft engine attached to it) was given and because the registration correctly refers to the present indebtedness of the debtor, the creditor may argue that, at least at this stage, the registration should remain effective. But it is not clear whether it is possible to sever the correct part of the registration information from the incorrect addition which relates to future debts that may be incurred by the debtor. On the other hand, obtaining of consent of the other party is a prerequisite to the effective registration. Consequently, it may be argued that exceeding the granted consent, similar to obtaining consent from a wrong person or in relation to a different object, should invalidate the registration altogether. This result may seem harsh since it leads to the loss of priority by the secured creditor who may have committed an innocent mistake. But the requirement of consent was specifically designed to deal with incorrect or improper registrations. Therefore, it may be argued that if such consent is exceeded, than similar to the case where it was inappropriately obtained, it should result in invalidation of the registration.

Although the Convention undoubtedly governs the issues relating to registrations in the International Registry, the question of whether partial invalidation of a registration is possible is not expressly settled in it. The answer to this question may be found with the help of the general principles and objectives on which the Convention is based.<sup>289</sup> One of the main objectives of the Convention is promotion of asset-based financing which can be achieved through ensuring that interests of creditors are recognised and protected.<sup>290</sup> If the creditor can be certain that its interest will not be jeopardised by a minor mistake and that it will be allowed to retain its priority, the risks associated with the repayment of the debt will decrease. As a result, the creditor should be able to provide credit to a greater range of debtors and at a lower interest rate which should help promoting

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<sup>288</sup> Similarly, Revised Article 9 does not seem to address this issue. See M Jennings, 'Yes, Dear Lawyer, There is a New, Revised, and Even More Complex Article 9' (2001) 30 Real Estate L J 20.

<sup>289</sup> Art 5(2).

<sup>290</sup> See the Preamble of the Convention.

asset-based financing. If the creditor's mistake in the above illustration has the effect of invalidating the registration, the creditor can still effect a new registration reflecting the true agreement between the parties. Although the creditor will be allocated a new priority status, its original priority position will be lost. In contrast, if it were possible to avoid the incorrect part of the registration relating to future indebtedness and retain the effectiveness of the correct part, the creditor would be able to retain its priority position as was initially intended by the parties. Allowing partial invalidation of the registration may then be considered as better reflecting the main objective of the Convention, i.e. promotion of asset-based finance and protection of creditor's interests.

A possible objection to this outcome may come from the debtor and its other creditors. If the registration remains in its current form, the debtor may have difficulty in securing loans from other creditors. The mistake relating to future indebtedness appears to enlarge the extent of the registered security interest which may deter other creditors from providing the debtor with a loan. Moreover, if the registration is effective in relation to its correct part, but is left in its current form, this may go counter to the general principle of transparency on which the Convention is based. This principle can be observed through rules of registration of international interests designed to give notice of their existence to third parties.<sup>291</sup> The registration covering future indebtedness of the debtor may mislead subsequent creditors as to the extent of this interest, which may disrupt transparency of the registration system. However, this situation can be easily remedied if the parties agree and register an amendment clarifying the true extent of the registered interest.<sup>292</sup> As long as the amendment does not relate to the change of registration information identifying the object or to the category of the registration, the amended registration will not be treated as a new one, and the creditor will be able to retain its original priority position.<sup>293</sup> In any event, the subsequent creditors searching the register will still be able to detect that a security interest may exist in the aircraft object of the debtor. Once this information is obtained, the subsequent creditors should be able to contact the

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<sup>291</sup> Goode (n 11) 18.

<sup>292</sup> S 12.6 of the Regulations.

<sup>293</sup> S 5.11(a), (d) of the Regulations.

holder of the registered security interest in order to clarify the extent of its interest.

The option of registering an amendment may not be readily available if the creditor refuses to consent to the change of the relevant registration information.<sup>294</sup> Since the functions of the Registrar are merely administrative, it cannot be expected to adjudicate on such matters as whether an amendment should be registered even if consent of the other party cannot be obtained. In this case the debtor can apply to a court of the State where the Registrar has its centre of administration for an order directing the Registrar to effect the relevant amendment.<sup>295</sup>

Since the registration will only become effective and searchable after the consent of the other party is obtained, it is difficult to see how it can be effected without the prior consent.<sup>296</sup> But the consent may have been transmitted by a person who was not entitled to do so and the Registrar, not having the means to verify facts external to the registration process, may have proceeded with the registration. In this case, the registration will not be effective or valid even if it appears as such on the register.<sup>297</sup> The Convention does not expressly list other grounds<sup>298</sup> which may invalidate the registration, but if, for example, the chargor, conditional seller or lessor has no power to dispose of the object or if some other formal requirements necessary for the creation of the international interest are not complied with, the purported registration of such interest will not be effective.<sup>299</sup> So too, registration of a registrable non-consensual right or interest and registration of a notice of a national interest in the International Registry will only be effective if these rights and interests were validly created under the applicable domestic law. Similarly, if the agreement creating or providing for the international interest was concluded at the time when the debtor was not situated

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<sup>294</sup> Art 20(1) of the Convention states that any amendment of the registration relating to the international interest may be effected by either party with consent of the other. Accordingly, if the debtor wishes to amend the registration, it will have to secure consent of the creditor allowing it to do so.

<sup>295</sup> Goode (n 11) 55.

<sup>296</sup> Goode (n 11) 205.

<sup>297</sup> This is the effect of Art 19(1) and Art 20 of the Convention.

<sup>298</sup> In contrast, Art 9-516 UCC specifically lists grounds on which the filing officer can reject the financing statement. For example, if the fee is not tendered or the type of organisation is not stated in the financing statement, it can be rejected at the filing office. See, generally, I Hillinger and M Hillinger, '2001: A Code Odyssey (New Dawn for the Article 9 Secured Creditor)' (2001) *Com L J* 105.

<sup>299</sup> Art 7.

in a Contracting State, the interest would not be valid and its registration would have no effect.

#### 4.3 Searches and search certificates

To effect a registration, a registering party must comply with Regulations and Procedures of the International Registry. This is likely to involve making prior arrangements with the Registry, employing an administrator, complying with the formal requirements and obtaining consent of the other party. In addition, if a Contracting State has designated an entry point, the registration information must also be submitted to such entry point before it can be transmitted to the International Registry in order to become searchable and valid. The main purpose of these measures is to ensure that the International Registry is reliable and that it is not burdened by improper or incorrect registrations. In contrast, searches of the International Registry may be electronically conducted by any person whether or not it has a specific interest in the aircraft object.<sup>300</sup>

Registration of interests in the International Registry is made against a uniquely identifiable aircraft object. For this reason, a search criterion, which consists of several elements, is also made up of information identifying the object.<sup>301</sup> The search can be made using the information regarding a) a manufacturer's name, b) a manufacturer's general model designation and c) a manufacturer's serial number of the aircraft object.<sup>302</sup> If the registration relates to an airframe or helicopter (but not to the aircraft engine) the search of any interests in these objects can also be conducted against d) the State of Registry of the aircraft of which such airframe is part or e) the nationality or registration mark of these objects.<sup>303</sup> Once the search is ordered and the prescribed fee is paid, the

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<sup>300</sup> Sec 7.1 of the Regulations.

<sup>301</sup> Since the Space Protocol is not yet in force, it is not clear whether a search criterion based on the information about the obligor or the information identifying the object or a combination of both will be used to locate registrations in the International Registry. See P Larsen, 'Future Protocol on Security Interests in Space Assets' (2002) *J Air L Comm* 1071, 1089. In contrast to the approach under the Convention, Australian Draft Bill on personal property security law, which is not yet in force, provides that access to a registry for the purposes of searches should be limited to specified persons. See P Quirk, 'Whether Australian Secured Transactions Law will Transform from the English System to the Personal Property Securities Act?' (2008) 31 *T Jefferson L Rev* 219, 247.

<sup>302</sup> Sec 7.1 of the Regulations.

<sup>303</sup> Sec 7.1 of the Regulations.



Registrar is required to issue the searching party with an electronic search certificate which should be digitally signed by the former if it is to be valid.<sup>304</sup> It is possible to order three types of searches, two of which, namely, a priority search and a Contracting State search are official, while the third, the information search, does not have any significance for the purpose of priority.<sup>305</sup>

The priority search is essentially a search for any registered international and other interests which may exist in the aircraft object.<sup>306</sup> Once the Registrar receives a request for the priority search, it should issue an electronic priority search certificate indicating all those interests which are registered in the International Registry in relation to the aircraft object as well as the names of the holders of such interests.<sup>307</sup> The searching party should then be able to contact the holders of prior registered interests and obtain more detailed information in relation to the status and extent of their interests in the object held by the debtor. The certificate should also provide the searching party with a transactional history of each registered interest.<sup>308</sup> For example, if the duration of the registered international interest was extended for 5 years, or if the registered interest was subordinated to another creditor, or if it was assigned to another party, these changes should be reflected in the certificate. The certificate must also state the date and time of registered information and all registrations should be listed in chronological order.<sup>309</sup> This information can help the searching party to assess what its position would be in the queue of other creditors should the debtor be struck by insolvency. The priority search certificate should be issued even if no interests were registered in relation to the object.<sup>310</sup> In this case, the certificate will simply state that no information was recorded in respect of the object.<sup>311</sup>

Some interests, such as non-registrable non-consensual rights and interests may be binding on the searching party even if they cannot be registered in the International Registry. This may be the case if a Contracting State makes a relevant declaration under Article 39 of the Convention. Although the searching party cannot establish whether these rights and interests exist from the register, it

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<sup>304</sup> Sec 13.4 of the Procedures.

<sup>305</sup> Ss 7.2-7.5 of the Regulations.

<sup>306</sup> Goode (n 11) 211.

<sup>307</sup> Art 22(2)(a) of the Convention.

<sup>308</sup> Sec 7.4(b)(ii) of the Regulations.

<sup>309</sup> Art 22(2)(a) of the Convention and Sec 7.4(b)(i) of the Regulations.

<sup>310</sup> Goode (n 11) 211.

<sup>311</sup> Art 22(2)(b) of the Convention.

can order a Contracting State search certificate revealing all declarations made by the Contracting State. There is, therefore, no need to seek this information elsewhere and the International Registry can be used as a central point from which the existence of these declarations can be ascertained.<sup>312</sup> The list of declarations and their withdrawals is searchable in the International Registry against the name of the declaring State.<sup>313</sup> The Contracting State certificate may help the searching party to establish whether certain unregistered interests can be binding on it and the dates when declarations in relation to such interests came into effect.<sup>314</sup> The third type of search, namely, the information search can be conducted when the searching party does not have sufficient information to identify the object.<sup>315</sup> In this case, the International Registry can still provide the searching party with a list of possible matches and registered data in relation to such objects.<sup>316</sup> The information search certificate is issued without responsibility on the part of the International Registry and the searching party will still need to gather more information from the parties indicated in it.<sup>317</sup>

Finally, the certificate issued by the International Registry is *prima facie* proof that it was in fact so issued<sup>318</sup> and no additional evidence should be presented unless the authenticity of the document is challenged.<sup>319</sup> The certificate is a proof of the facts recited in it, including the date and time of registration<sup>320</sup> and can be used as such in order to assert priority status of its holder. In contrast, English law provides that a certificate issued by the Registrar is conclusive and its validity or content cannot be challenged even if it contains erroneous information.<sup>321</sup> For example, certificates indicating the wrong date of the creation of the charge,<sup>322</sup> the principal sum, but not the interest<sup>323</sup> and not delivered within

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<sup>312</sup> Goode (n 11) 212.

<sup>313</sup> Art 23.

<sup>314</sup> Art 23.

<sup>315</sup> Sec 7.3 of the Regulations.

<sup>316</sup> Sec 7.4 of the Regulations.

<sup>317</sup> Goode (n 11) 212.

<sup>318</sup> Art 24(a).

<sup>319</sup> Goode (n 11) 213.

<sup>320</sup> Art 24(b).

<sup>321</sup> For a suggestion that conclusiveness of certificate should be abandoned as incompatible with electronic registration procedures see D. Guild, 'The Registration of Rights in Security by Companies' (2002) *Scots Law Times* 289, 291.

<sup>322</sup> *In re C.L Nye Ltd* [1971] Ch. 442.

<sup>323</sup> *In re Mechanisations (Eaglescliffe) Ltd* [1966] Ch. 20.

the stipulated 21 day period, but still accepted by the Registrar<sup>324</sup> were upheld by the courts. Since the certificate is conclusive evidence that all necessary requirements of registration were complied with, the secured creditor can rely on its safety and rest assured that the validity of its security interest will not be later challenged.<sup>325</sup> The main reasons why the certificate is considered to be conclusive are twofold. First, it is the debtor who is generally under a duty to deliver the charge instrument and prescribed particulars to the Registrar for the purpose of registration.<sup>326</sup> Since the secured creditor cannot interfere in this process, it should not bear the consequences of mistakes which may be made by the debtor.<sup>327</sup> Secondly, once the charge instrument and the prescribed particulars are delivered to the Registrar, he should check them in order ‘...to form an independent judgment in reference to what he ought to put on the register...’.<sup>328</sup> This means that more mistakes may be made at this stage and the secured creditor, not being able to ensure the correctness of the registered information, should not bear the risk of the occurrence of such mistakes.<sup>329</sup> In contrast, the function of the Registrar under the Convention is purely administrative and it is not under an obligation to verify the information submitted to it. Consequently, a certificate issued by the International Registry is only *prima facie* proof of the facts stated in it and its content may be challenged. For example, if the certificate wrongly states that no interests were registered in relation to a specific aircraft engine and the searching party is induced to advance a loan to the debtor in reliance on this information, the searching party may be entitled to pursue a claim against the Registrar for the loss suffered as a result of this mistake.<sup>330</sup>

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<sup>324</sup> *Regina v Registrar of Companies, ex parte Central Bank of India* [1986] Q.B. 1114.

<sup>325</sup> *Exeter Trust Ltd v Screen Ways Ltd* [1991] B.C.C. 477.

<sup>326</sup> Sec 399 of the Companies Act 1985.

<sup>327</sup> *National Provincial and Union Bank of England v Charnley* [1924] 1 K.B. 431, 443. In practice, it is usually the creditor who arranges for the documents to be delivered for registration. This is thought to be the case because the creditor has a stronger incentive to ensure registration as failure to register results in loss of priority. See McCormack (n 67) 6.2-6.3.

<sup>328</sup> *National Provincial and Union Bank of England v Charnley* [1924] 1 K.B. 431, 443.

<sup>329</sup> *Ibid* 443-444.

<sup>330</sup> Goode (n 11) 213.

#### 4.4 Discharge of registration

Once the debtor performs the obligations secured by the registered international interest or when the obligations giving rise to a registered non-consensual right or interest have been fulfilled, the debtor is entitled to obtain a discharge from the International Registry.<sup>331</sup> This does not mean that the registered information will be removed from the register.<sup>332</sup> Instead, a new record stating that the interest has been discharged will appear on the system.<sup>333</sup> In order to obtain a discharge, the debtor should deliver to the holder of the registered interest a written demand requesting it.<sup>334</sup> Upon receipt of the demand, the creditor should procure the discharge without undue delay, which in the case of aircraft objects amount to 5 working days<sup>335</sup> and in the case of railway objects no later than 10 calendar days after the receipt of the demand.<sup>336</sup> Whether it is possible to obtain a discharge of a prospective international interest or prospective assignment of an international interest will depend on the intending creditor or assignee's commitment to give value.<sup>337</sup> In other words, if the intending creditor or assignee has not yet provided any funds to the debtor and negotiations between the parties cannot be proceeded, the debtor is entitled to have prospective interests discharged.<sup>338</sup> In contrast, if the intending creditor or assignee has made at least a partial payment to the debtor, the registered interest cannot be discharged until the debt is fully repaid.<sup>339</sup> Finally, where a registration has been improperly or incorrectly made, the debtor is also entitled to the discharge or amendment and this should be procured by the holder of such interest.<sup>340</sup>

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<sup>331</sup> Art 25(1). In contrast, registration of a contract of sale (but not of a prospective sale) of aircraft object cannot be discharged as it continues indefinitely. Art V(3) of Aircraft Protocol.

<sup>332</sup> Goode (n 11) 213.

<sup>333</sup> Ibid 213.

<sup>334</sup> Art 25(1).

<sup>335</sup> Art XX(2) of the Aircraft Protocol.

<sup>336</sup> Art XV(2) of the Luxembourg Protocol.

<sup>337</sup> Art 25(2).

<sup>338</sup> Art 25(2).

<sup>339</sup> Goode (n 11) 216.

<sup>340</sup> Art 25(4). If the responsible party refuses to procure the discharge of the registration, the debtor has an option to apply for a court order instructing the Registrar to correct the records in the International Registry. This issue should be considered in the courts of the place in which the Registrar has its place of administration. Art 44(1) of the Convention. See also Cumming (n 37) 42.

## Chapter IV: Priority of Competing Security and other International Interests

### 1. General

The secured creditor providing a loan to the debtor is unlikely to be the only creditor claiming an interest in the high value mobile equipment held by it. The debtor may have already granted a security interest to a previous creditor, leased the asset to a lessee, or negotiated its sale with an outright buyer. In addition, a holder of a non-consensual right or interest, such as a repairer who did not receive payment for its services, or a holder of a national interest who has registered its notice in the International Registry, may also attempt to establish their claims in the asset subject to the interest of the secured creditor. If the debtor remains solvent and capable of meeting its obligations, the secured creditor may rest assured that the loan will be repaid at some point. On the other hand, should the debtor become insolvent, it may not have enough assets to meet the obligations it owes to various creditors. In this case, creditors will need to know whether the debts will be repaid on a first-come-first-served basis or whether the repayment will depend on the size of the debt, the time when the obligation was incurred or on some other criteria.

The main function of priority rules is to establish the order in which competing creditors may satisfy their claims from the asset held by their common debtor.<sup>1</sup> In addition, a clear set of priority rules may help the creditor ascertain its position in the queue of creditors in advance, which may influence its decision to extend the loan in the first place. By assessing its relative position among other creditors, the potential secured creditor may estimate whether the debtor will have enough funds to repay the loan after all previous claims have been met. If the asset is already heavily encumbered and the secured creditor is unlikely to receive full repayment, it may decide to enter into a subordination agreement with one of

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<sup>1</sup> T Jackson and A Kronman, 'Secured Financing and Priorities Among Creditors' (1978-79) 88 Yale L J 1143, 1144. Priority rules do not govern the cases of double debtor on which see R Wood, 'The Double Debtor Problem and the Boundaries of the Residual Priority Rule: Northwest Equipment Inc. v. Daewoo Heavy Industries America Corp.' (2002) 18 Banking Finance L Rev 129.

the senior creditors or not to lend at all.<sup>2</sup> Finally, priority rules accepted by all creditors may bring certainty in that once the priority position of the secured creditor is established it will be recognised by subsequent creditors as well as by the insolvency administrator. In other words, priority enjoyed by the secured creditor may help protect its stake in the asset from competing claims of other creditors, which may be one of the reasons for taking the security interest rather than extending an unsecured loan in the first place.<sup>3</sup>

The priority rules of the Convention are keyed to the time of registration in the International Registry.<sup>4</sup> The general rule is that a registered interest has priority over a subsequently registered interest and over an unregistered interest.<sup>5</sup> This means that registration is not only a perfection, but also a priority point.<sup>6</sup> In

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<sup>2</sup> For other options available to a secured creditor see P Coogan, 'Article 9 of the Uniform Commercial Code: Priorities among Secured Creditors and the 'Floating Lien'' (1959) 72 Harv L Rev 838, 859-860.

<sup>3</sup> V Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 MLR 633, 634. For other reasons why a creditor may decide to take a security interest see R Mann, 'Strategy and Force in the Liquidation of Secured Debt' (1997-98) 96 Mich L Rev 159.

<sup>4</sup> R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*, Revised edn (Rome, UNIROIT 2008) 65. Similarly, British Columbia Personal Property Security Act determines priorities by the order of registration. For a comment on whether other requirements, such as the requirement of a signed written security agreement, may amount to priority rules see J Ziegel, 'Interaction Between Writing Requirements and First to File Priority Rule in the British Columbia Personal Property Security Act: 674921 B.C. Ltd. v. Advanced Wing Technologies Corp.' (2006) 22 Banking Finance L Rev 117.

<sup>5</sup> Art 29(1). The priority rule is similar under the US Uniform Commercial Code (UCC). S. 9-322(a)(1) of Article 9 states that as between two security interests, first to file gets priority. In contrast, English law gives priority to the first-in-time of creation, but this rule is subject to several exceptions. At the same time under the UK Mortgaging of Aircraft Order 1972 a registered mortgage or charge over an aircraft has priority over an unregistered one and priorities between registered mortgages or charges in the same aircraft are determined by the order of registration. See P Thorne, 'Aircraft Mortgages' in N Palmer and E McKendrick (eds), *Interests in Goods*, 2<sup>nd</sup> edn (LLP, London 1998) 712; R Calnan, 'Taking Security in England' in M Bridge and R Stevens (eds), *Cross-Border Security and Insolvency* (Oxford, OUP 2001) 26. This is also true of priorities between holders of interests in land and priorities determined by some specialist registries. For example, ss 28-29 of the Land Registration Act 2002 under English law stipulate that priorities between mortgages registered as legal charges are determined by the order of registration. Likewise, priority between holders of security interests in objects of intellectual property is determined by the order of registration in the Patent Office. See V Bromfield and J Runeckles, 'Taking Security Over Intellectual Property: A Practical Overview' (2006) *European Intellectual L Rev* 334; M Dixon, 'Priorities under the Land Registration Act 2002' [2009] *LQR* 401. Similarly, German law accords priority to the first-in-time of creation, but the rule is subject to two exceptions, namely, 1) the subsequent acquisition of the security interest in good faith and 2) the subordination of certain advance transfers, such as bulk assignments. See J Hausmann, 'The Value of Public Notice Filing Under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property' (1996) 25 *Georgia J Int'l Comp L* 427, 469.

<sup>6</sup> Goode (n 4) 224. Under English law, registration is irrelevant for the purpose of determining the order of priorities. It may only have relevance if a registrable interest is not registered within 21 days of creation because it becomes void against the liquidator and creditors of the company. This

order to determine its priority position, the secured creditor has to search the International Registry. The search should reveal whether it will be the first creditor claiming an interest in the debtor's object or whether its interest is likely to be subjected to a registered interest of a senior creditor. By registering its interest, the secured creditor may ensure that its priority position will be crystallised among other registered and unregistered interests and that it will be visible to other searching parties.<sup>7</sup>

Registration is the only mode of perfection and the only requirement for obtaining a priority under the Convention.<sup>8</sup> In contrast, some other legal systems recognise that in order to perfect a security interest in certain types of objects, the secured creditor may either register or file a financing statement at a filing office or take possession or control over the collateral.<sup>9</sup> Such systems may have several hierarchies of priority rules.<sup>10</sup> If competing interests are perfected by the same mode of perfection, such as filing, then as between two filed security interests, first to file will take priority.<sup>11</sup> On the other hand, if competing security interests are perfected by different modes, such as control and filing, the resolution of conflict between them may depend on which type of perfection is given priority by the legislator. Should perfection by control be granted priority, then a security interest perfected in this way will take priority over the filed competing interest even if the latter was perfected earlier than the former.<sup>12</sup>

Since registration is the only way of perfecting and obtaining priority under the Convention, the only relevant distinction between competing interests is that of registered and unregistered interests. This means that other considerations, which may be important in some legal systems, such as location of title to the

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means that other security interests may be promoted into the place of the avoided security. In addition, in some cases, registration may constitute constructive notice of the existence of security interests which may have some effect on the order of priority between holders of competing interests. See G McCormack, *Registration of Company Charges*, 2 edn (Jordans 2005) 7.3.

<sup>7</sup> For a more detailed discussion of the issues of registration see Chapter III.

<sup>8</sup> Similarly, under Croatian law priorities between competing interests are determined by the order of registration. See T Jocić, 'The Rail Protocol and Croatian Secured Transaction Law' (2007) *Unif L Rev* 489, 503.

<sup>9</sup> This is the position under the US UCC. See s. 9-313(a) (perfection by possession or delivery) and s. 9-314(a) (perfection by control) of Article 9. See P Coogan, 'A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code' (1963) *Colum L Rev* 1, 28-29.

<sup>10</sup> R Picker, 'Perfection Hierarchies and Nontemporal Priority Rules' (1999) 74 *Chi-Kent L Rev* 1157.

<sup>11</sup> S 9-322(a)(1) of Article 9 UCC. See J White and R Summers, *Uniform Commercial Code*, 5<sup>th</sup> edn (West Group, 2000) Chapters 23-24.

<sup>12</sup> Picker (n 10) 1164-65.

object, are irrelevant for the purposes of priority under the Convention. For example, some legal systems provide that interests of conditional seller and lessor under a title reservation agreement and lease do not have to be registered in order to gain priority over a registered security interest.<sup>13</sup> Conditional seller and lessor retain their title to the object until conditional buyer or lessee pay the purchase price or the rentals and this alone exempts them from the necessity to register and justifies their priority over registered security interests. In contrast, the Convention does not grant super-priority to selected types of interests and conditional seller or lessor will have to register their international interests in order to protect their priority positions against other competing interests.

Registered interests are not confined to international interests of secured creditor, lessor and conditional seller, but include other registrable interests, such as assignments of international interests, notices of national interests as well as registrable non-consensual rights and interests.<sup>14</sup> A registered interest will have priority over an unregistered interest irrespective of whether the unregistered interest can be registered in the International Registry. For example, if a consensual or a non-consensual right or interest, such as a pledge or a repairer's lien, is not registered in the International Registry because it does not require registration under applicable domestic law, it will be considered as an unregistered interest under the Convention and will be subjected to the interest registered in the International Registry.

Similar to other legal systems, the general rule of priority under the Convention is subject to a number of exceptions. One of the objectives of this Chapter will be to examine these exceptions in an attempt to assess the degree of erosion they cause to the general rule.

The priority accorded to a registered international interest and the protection against competing claims it offers to the secured creditor will become of particular importance in the case of the debtor's insolvency. Only a duly registered interest will be able to retain its priority and survive insolvency of the debtor.<sup>15</sup> The effect of insolvency on the security and other international interests will also be considered in this Chapter.

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<sup>13</sup> This is the position under English law. See H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (Oxford, OUP 2007) 431.

<sup>14</sup> Art 16(1).

<sup>15</sup> Art 30(1).



Finally, one of the effects of granting a security interest is that the secured creditor can satisfy its claim in priority to a claim of an unsecured creditor.<sup>16</sup> On the one hand, it may seem unfair that by entering into a private security agreement the debtor and the secured creditor may alter the position of an unsecured creditor in such a way as to leave it with a very slim chance of obtaining the repayment in the case of the debtor's insolvency.<sup>17</sup> On the other hand, it may be argued that voluntary unsecured creditors can reduce their risks by charging higher interest rates<sup>18</sup> and that the debtor should be able to alienate its property rights in the objects by way of security as freely as possible.<sup>19</sup> The Convention does not deal with the issues of priority between secured and unsecured creditors and is only concerned with priority conflicts between registered and unregistered holders of security and other international interests. For this reason the issues of justification of the privileged position enjoyed by secured creditors in relation to unsecured creditors will not be addressed in this Chapter.

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<sup>16</sup> For a view that priority of secured creditors should not be disturbed because unsecured creditors are unlikely to benefit from that see D Baird, 'The Importance of Priority' (1997) 82 Cornell L Rev 1420.

<sup>17</sup> For a discussion reflecting similar concerns in the context of Canadian Personal Property Security Acts see J Ziegel, 'The New Personal Property Security Regimes – Have We Gone too Far?' (1989-90) 28 Alta L Rev 739. See also R Mokal, 'Priority as Pathology: The Pari Passu Myth' [2001] CLJ 581 claiming that the pari passu rule that creditors should be treated on an equal footing should not be regarded as a default rule due to the many exceptions to it. For a debate on the position of unsecured creditors and propositions to cut full priority of secured creditors see L Bebhuk and J Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale L J 857; S Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy' (1997) 47 Duke L J 425; L LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80 Va L Rev 1887; S Block-Lieb, 'The Unsecured Creditor's Bargain: A Reply' (1994) 80 Va L Rev 1989.

<sup>18</sup> Jackson and Kronman (n 1) 1148. For a discussion on the position of non-adjusting non-voluntary unsecured creditors see S Harris and C Mooney, 'Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy' (1997) 82 Cornell L Rev 1348;

<sup>19</sup> S Harris and C Mooney, 'A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously' (1994) 80 Va L Rev 2021, 2022; L Ponoroff and F Knippenberg, 'Having One's Property and Eating it Too: When the Article 9 Security Interest Becomes a Nuisance' (2006) 82 Norte Dame L Rev 373. There were also attempts to justify the privileged treatment of secured creditors on the grounds of economic efficiency. For a more detailed discussion of these issues as well as attempts to solve the so called puzzle of the security interest see C Hill, 'Is Secured Debt Efficient?' (2002) 80 Tex L Rev 1117; J Fried, 'Taking the Economic Costs of Priority Seriously' (1997) 51 Consumer Fin L Q Rep 328; A Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 J Legal Stud 1; R Mann, 'Verification Institutions in Financing Transactions' (1999) 87 Geo L J 2225; R Scott, 'A Relational Theory of Secured Financing' (1986) 86 Colum L Rev 901; D Carlson, 'Secured Lending as a Zero-Sum Game' (1998) 19 Cardozo L Rev 1635; J White, 'Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules' (1995) 79 Minn L Rev 529.

## 2. The general rule: first-in-time, first-in-right

### 2.1 General

The general priority rule under the Convention consists of two limbs. First, as between two registered interests, the first to be registered gets priority.<sup>20</sup> This means that registration is the priority point and that the date of the creation of the international interest, the date when the loan was advanced to the debtor or the object was delivered to the lessee are not relevant for the purpose of establishing the order of priority between competing interests. If the debtor grants the first security interest in an aircraft engine to the secured creditor A on 1 May who registers its interest on 10 June and then grants the second security interest in the same engine to the secured creditor B on 12 May who registers its interest on 6 June, then B will be able to obtain repayment of the loan in priority to A, because its interest was the first to be registered in the International Registry. The result would be the same even if B had actual knowledge of the existence of the prior security interest.<sup>21</sup>

One of the consequences flowing from this rule is that it is possible to register the international interest first and create it later.<sup>22</sup> If the parties are negotiating the terms of a security agreement providing for a secured loan for the acquisition of an airframe, the secured creditor may register its interest as a prospective international interest before the security interest is created. Once all the prerequisites for the creation of the security interest are in place, for example, the debtor obtains power to dispose of the object by way of security the prospective interest will automatically convert into the actual international interest. In this case, priority of the security interest will date back from the time

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<sup>20</sup> Art 29(1).

<sup>21</sup> Art 29(2)(a). Knowledge, whether actual or constructive, of prior international interests is irrelevant under the Convention which helps avoiding factual disputes over what was known by the parties at any relevant time. It seems to be an accepted view that making the issue of priorities turn on factual disputes based on state of knowledge is likely to generate uncertainty and increase litigation. See McCormack (n 6) 7-11 – 7-16.

<sup>22</sup> Similarly, the UK Mortgaging of Aircraft Order 1972 permits registration of a priority notice stating that a charge or a mortgage is to be granted over an aircraft. If such security interest is registered within 14 days of the date of registration of the priority notice, the priority of the mortgage or charge will date back from the date of the registration of the priority notice. See Thorne (n 5) 712. This is also the case under s. 9-502(d) of Article 9 UCC. See Uniform Commercial Code: Official Text and Comments, 2009-2010 edn (Thomson West 2009) para 2, 1005.

of its registration as a prospective international interest. This allows the secured creditor to prevent any intervening claims from taking priority over its security interest.

Consider the following example. The debtor negotiates a lease of an airframe and an aircraft engine with a manufacturer and a loan which will be secured by these aircraft objects with the secured creditor. The debtor will need the secured loan to cover the rental payments during the first two years of the lease. The negotiations in relation to the loan start on 1 May and the secured creditor decides not to register its security interest until after the lease is finalised and the debtor has power to dispose of the objects by way of security. The lease is entered into on 15 August, the aircraft objects are delivered to the debtor on the same day and the lessor registers its interest on 20 August. The secured creditor registers its international interest on 15 September. The secured creditor later learns that before granting a lease, the manufacturer, who needed funds for the acquisition of new equipment which it intends to use in the manufacturing process, obtained a loan from its own creditor which was secured by the same aircraft objects as were offered to the debtor under the lease. The manufacturer's secured creditor registered its interest on 5 August. The debtor is now insolvent and the secured creditor will only be able to obtain repayment of the loan after the manufacturer and its own creditor satisfy their claims, which could have been avoided had the secured creditor registered its interest as a prospective international interest on 1 May.

Registration of a prospective international interest may, in some cases, also protect the security interest from possible attacks of the insolvency administrator.<sup>23</sup> If the insolvency administrator has a power under the applicable domestic law to avoid a security interest which was registered in the 90 days before commencement of the insolvency proceedings as a preference and the debtor became insolvent on 1 November, the insolvency administrator may be able to set aside the international interest of the secured creditor if it was registered on 15 September as a security interest, but not if it was registered on 1 May as a prospective international interest.

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<sup>23</sup> Art 1(k) of the Convention provides a broad definition of the insolvency administrator as a person authorised to administer the reorganisation or liquidation of the debtor. This term may cover a debtor in possession, trustee in bankruptcy, liquidator and administrator designated to deal with collective insolvency proceedings under domestic insolvency law. See also Goode (n 4) 158.

Another consequence which flows from the rule that a registered interest has priority over the subsequently registered interest is the following. Should the secured creditor 1 (SC1) who has registered its interest first, agree to advance further loans to the debtor on the security of the same aircraft object, it may add such loans to the original one in order to cover all sums by the same security interest. In other words, provided that all loans are secured by the same collateral, there will be no need to enter into a new security agreement and register a new security interest every time the additional loan is issued to the debtor. This will be the case even if in the period between the original security interest was registered and additional loans were provided, the debtor granted the secured creditor 2 (SC2) the second security interest in the same aircraft object which was immediately registered. This means that even if SC1 has actual knowledge of the existence and registration of SC2's interest, it may continue to add the loans advanced to the debtor to be secured by its registered security interest.<sup>24</sup> In this case, SC1 will be able to retain its priority position over SC2 in relation to all loans issued to the debtor and not only in relation to the original one. This arrangement can be of particular convenience to SC1 and the debtor if the latter maintains a bank account with SC1 and is allowed to draw on this account whenever it is in need of a fresh injection of funds. All such withdrawals can be linked to the originally registered security interest and SC1 does not have to search the registry in order to ensure that its interest in relation to further advances will not be postponed to the intervening interests of other creditors of the debtor. SC2, who will search the registry before granting the loan, will be in better position to notice SC1's security interest as well as to learn the details of the arrangement between SC1 and the debtor. SC2 can then agree to pay SC1 to buy out its priority position in relation to its own loan, assign its security to SC1, enter into a subordination agreement or simply ask the debtor to provide it with different collateral.

Finally, if a floating security interest over a fund of uniquely identified aircraft objects can be registered in the International Registry,<sup>25</sup> the rule that the registered interest prevails over the subsequently registered and unregistered

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<sup>24</sup> This is the effect of Art 29(2).

<sup>25</sup> For a discussion on whether it is possible to create and register a floating charge over the aircraft and railway objects see Chapter II.

interests should also apply to it.<sup>26</sup> For example, if SC1 registers a first floating security over airframes A, B and C and SC2 registers a second floating security over airframes D, E and F, SC1 will have priority as it was the first to register its security interest. Whether competing floating security interests can be taken over the same pool of aircraft objects under the Convention is not clear, but an answer may be offered by English law. In one case, a company created a first series of debentures charging its undertaking and all of its present and future property.<sup>27</sup> Ten years later, the second series of identical debentures was issued and the question arose whether the second debentures ranked *pari passu* with the first debentures or after them. It was held that the second debentures ranked after the first ones: the fact that the second debentures covered the same assets as the first ones defeated the whole purpose of the first debentures. Conversely, had the second debenture covered only part of the same assets or different objects altogether, the result would be different. In this case, the second floating charge could take priority over the first floating charge as creation of subsequent floating and fixed charges is considered to be within the ordinary course of debtor's business.<sup>28</sup> The same reasoning could, in principle, apply in the case of the Convention: if both floating security interests cover the same aircraft objects of the debtor, then the second security would rank after the first one as otherwise the purpose of the earlier security would be defeated. However, the result under the Convention will ultimately depend simply on the order of registration of competing security interests. So if SC2 registers its floating security before SC1, SC2 will take priority over its competitor. The time of registration will also determine the order of priority between SC1 who takes a registered floating security over aircraft objects A, B, and C and SC2 who registers a fixed security in aircraft object C. In contrast to English law where fixed charges are accorded priority over floating charges,<sup>29</sup> the outcome under the Convention will depend on which of the two secured creditors registered its security first.<sup>30</sup>

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<sup>26</sup> Similarly, priority between recently introduced competing floating security interests under French law is determined by the order of registration. See G Ansaloni, 'Reflection on the Implementation of a Floating Security Interest Over Tangible Property in French Law (Study of the New Non-Possessory Pledge)' (2009) IBLJ 35.

<sup>27</sup> *In Re Benjamin Cope & Sons, Limited* [1914] 1 Ch. 800.

<sup>28</sup> *In Re Automatic Bottle Makers, Limited* [1926] Ch 412.

<sup>29</sup> *Castell & Brown Ltd, Re* [1898] 1 Ch. 315; H Sevenoaks, 'Financing Requirements in the 21st Century and the (In)adequacy of the Floating Charge' (2009) ICCLR 17. Although the general rule is that priority between competing interests is determined by the order of creation, a fixed charge

The second limb of the general priority rule under the Convention is that, as between registered and unregistered interests, priority goes to the registered interest even if its holder knows of the existence of the unregistered interest.<sup>31</sup> This will be the case even if the unregistered interest is not registrable under the Convention.<sup>32</sup> For example, if the debtor delivers one of its airframes under a pledge to the secured creditor A, whose interest is not registrable under the domestic law and is also not registered in the International Registry, and then grants a floating charge over several uniquely identifiable airframes including the one covered by the pledge to the secured creditor B, who registers its interest in the International Registry, the international interest of B will prevail as a registered interest.<sup>33</sup>

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is given priority over a floating charge irrespective of the order in which they were created. This can be explained by the fact that a chargor under a floating charge can deal with its assets by way of granting a fixed charge as long as it is in the ordinary course of business. Another explanation is that priority rules in English law are based on the 'strength' of security interests in terms of their specificity, publicity and enforcement and that the fixed charge is a 'stronger' security than a floating charge. See I Chiu, 'Replacing the Default Priority Rule for Secured Creditors-Some Reservations' [2006] JBL 644, 646.

<sup>30</sup> Since priority under the Convention is determined by the order of registration and not by other factors, such as the date of creation or the nature of the security, it appears that the floating security will not be automatically postponed to the fixed charge and preferential debts as is the case under English law. See s. 40 and s. 175(2)(b) Insolvency Act 1986. See also *Re H&K Medway Ltd* [1997] 1 WLR 1422; *Wheatley v Silkstone and Haigh Moor Coal Company* (1884) 29 Ch D 715; *Cox Moore v Peruvian Corporation Ltd* [1908] 1 Ch 604; *Re Colonial Trusts ex p Bradshaw* (1879) 15 Ch D 465. The Convention also does not require that a prescribed portion of funds should be set aside from the objects subject to a floating security interest for the benefit of unsecured creditors as is the case under s. 176A of the Insolvency Act 1986. For a discussion of the proposals of the Law Commission in relation to making the timing of registration determinative of the order of priority and the effects this would have on the floating charge under English law see G McCormack, 'The Floating Charge and the Law Commission Consultation Paper on Registration of Security Interests' (2003) *Insolvency Lawyer* 2. For the effects of the Enterprise Act 2002 on the floating charge in relation to the abolition of Crown preferences and introduction of the prescribed part for the benefit of unsecured creditors see E Smith, 'Secured Lenders Have no Recourse to Prescribed Part' (2008) *JIBLR* 338; A Walters, 'Statutory Redistribution of Floating Charge Assets: Victory (Again) to Revenue and Customs' (2008) *Company Lawyer* 129; E White, 'Insolvency: Floating Charge' (2008) *JIBLR* 58; E White, 'Insolvency: Preferential Creditors' (2008) *JIBLR* 50; D Henderson, 'Problems in the Law of Property After Spectrum Plus' (2006) *ICCLR* 30; I West and R Miller, 'Enterprise Act 2002: Issues for Secured Lenders' (2004) *JIBLR* 88. For the discussion on priority conflicts between a liquidator in relation to its expenses and a holder of a floating charge see H Rajak, 'Liquidation Expenses Versus A Claim Secured By a Floating Charge' (2005) *Insolvency Intelligence* 97; A Walters, 'Floating Charges and Liquidation Expenses' (2006) *Company Lawyer* 193.

<sup>31</sup> Art29(1).

<sup>32</sup> Art 1(mm).

<sup>33</sup> The outcome would be different under English law because pledge as a non-registrable interest does not have to be registered to maintain its priority. Moreover, as a first in time of creation as well as being a legal interest, the pledge would usually beat the equitable charge of the secured creditor B, unless the charge was authorized by the pledgor. See Beale, Bridge, Gullifer, *Lomnicka* (n 13) 418; *Franklin v Neate* (1844) 13 M&W 481 ER 200. The Convention, of course, does not distinguish between equitable and legal interests. For a discussion on the balance of

The general rule according to which registered interest prevails over the subsequently registered and unregistered interests is equally applicable to the assignment of associated rights under the Convention.<sup>34</sup> A holder of an international interest (secured creditor, conditional seller or lessor) can assign its interest together with associated rights (such as rights to payment under the security agreement, conditional sale or lease) to the assignee.<sup>35</sup> Unless otherwise agreed, the assignment transfers to the assignee all the interests and priorities of the assignor.<sup>36</sup> Since the assignee merely steps into the shoes of the assignor, it does not have to register its interest in order to retain its priority against creditors of the debtor. So if the debtor grants registered security interests in an airframe to A, B and C (which are registered in that order) and A assigns its registered interest to A1, A1 will have priority over B and C even if it does not register its interest in the International Registry.<sup>37</sup> The situation would be different if A assigned its interest in the airframe together with the associated rights to A1, A2 and A3. In this case, A1 will have to register its interest in order to protect its priority against A2 and A3. Failing that and provided that A2 and A3 register their interests in due course, A1's interest will be postponed to the interests of registered assignees.<sup>38</sup> This is precisely where the general rule of priority becomes relevant: as between two (or more) competing assignments, the registered assignment will have priority

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interests between holders of legal mortgages and equitable interests in the context of English law see P Omar, 'Equitable Interests and the Secured Creditor: Determining Priorities' (2006) *Conveyancer and Property Lawyer* 509.

<sup>34</sup> Art 35(1). Under English law, priority between competing assignments is governed by the principle which is known as the rule in *Dearle v Hall*: the priority between assignees is governed by the order of giving notice of the assignment to the debtor. The assignee giving notice should not know of the previous assignment at the time of its assignment or when the advance is transferred. See generally, *Dearle v Hall* (1828) 3 Russell 1; *Marchant v Morton, Down & Co* [1901] 2 K.B. 829; Note that notice is relevant only to the order of priorities and not to the validity of the assignment. See *Gorringe v Irwell India Rubber and Gutta Percha Works* (1887) L.R.34 Ch. D. 128; If the assignee does not give notice to the debtor before the debtor pays the debt to its original creditor, the assignee cannot make the debtor pay to him as well. See *Bence v Shearman* [1898] 2 Ch. 582. For a suggestion that the rule should be limited to its first limb only as the second limb is not supported by a clear authority see J D Lacy, 'The Priority Rule of *Dearle v Hall* Restated' (1999) *Conveyancer and Property Lawyer* 311; For a view that the rule in *Dearle v Hall* should be substituted to the one where priority is determined by the order of registration see C Brown, 'Preserving Priority in Receivable Financing: Time to Revisit *Dearle v Hall*' (1995) *J Int'l Bank L* 3.

<sup>35</sup> Associated rights are not confined to rights to payment and may include non-monetary obligations of the debtor relating to repair, maintenance and insurance as long as they are secured by or associated with the object. See Goode (n 4) 236.

<sup>36</sup> Art 31(1)(b). The position is similar under the Canadian Personal Property Security Act 1990. See A Duggan, 'The PPSA and the Common Law' (2005) *New Zealand Business Law Quarterly* 122, 126-128.

<sup>37</sup> Goode (n 4) 238.

<sup>38</sup> *Ibid* 238.

over the subsequently registered and over the unregistered assignment of associated rights.<sup>39</sup> It should be noted that the general rule of priority applies only if at least one of the competing assignments of associated rights also transfers to the assignee the international interest and if that assignment is registered.<sup>40</sup>

It is, of course, possible to transfer associated rights without the related international interest as where the lessor transfers its rights to rental payments to the assignee, but retains its international interest of the lessor. But such assignment will not be governed by the Convention because it is primarily concerned with interests in objects and not with associated rights as such (which, unless they are linked to the object cannot be registered under the Convention).<sup>41</sup> So if two competing assignments merely transfer the associated rights and not the related international interest and if such assignments are not registered, the general priority rule and the Convention itself will not apply and the conflict should be resolved by the applicable domestic law.<sup>42</sup> On the other hand, if at least one of the assignments of associated rights also transfers the related international interest and if such assignment is registered, then the priority rule of the Convention will apply.<sup>43</sup> In this case, the registered assignment will have priority over the unregistered assignment even if the latter cannot be registered in the International Registry because it is not linked to the object.

Finally, it should be possible to assign unregistered international interest together with the associated rights, since the Convention provides for the registration of assignments of international interest without specifying that such interest should itself be registered.<sup>44</sup> The assignee of the unregistered international interest should register the assignment or risk subordination to the holder of a subsequent international interest if the latter registers its interest before the assignee.<sup>45</sup>

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<sup>39</sup> This is the effect of Art 35(1).

<sup>40</sup> Art 35(1).

<sup>41</sup> Goode (n 4) 246.

<sup>42</sup> Ibid 77.

<sup>43</sup> Art 35(1).

<sup>44</sup> Art 16(1)(b). See Goode (n 4) 79.

<sup>45</sup> Goode (n 4) 79.



## 2.2 The possibility of purchase money security interest (PMSI)

### a) The need for the PMSI

In some legal systems the creditor is permitted to extend a loan secured on present and future property of the debtor.<sup>46</sup> This can be achieved by incorporating an after-acquired property clause into the security agreement.<sup>47</sup> This clause allows the parties to save transaction costs in that there will be no need to enter into a fresh security agreement every time new property of the type covered by the original security interest is acquired by the debtor, which may be particularly convenient if the objects used as a security are of such nature that they are likely to be turned over frequently in the course of the debtor's business.<sup>48</sup> The incorporation of the after-acquired property clause also means that the secured creditor will be able to retain its original priority position in relation to the future property of the debtor without the need to perfect a fresh security interest.<sup>49</sup> On the other hand, the after-acquired property clause creates the so called 'situational monopoly' which may place the debtor and its subsequent creditors into a disadvantageous position: should the secured creditor refuse further loans to the debtor, it may be difficult for it to obtain finance from subsequent creditors if they are to receive only a subordinate interest in the collateral.<sup>50</sup> It may also be suggested that allowing the prior secured creditor to enhance its security interest at the expense of the subsequent secured creditor providing fresh finance to the debtor may be greatly inequitable.<sup>51</sup> To avoid the pervasiveness of the after-acquired property clause, some legal systems allow the debtor to grant a purchase

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<sup>46</sup> See, for example, H Tjio, 'Personal Property Security Interests in Singapore and Malaysia' (1995) *Company Lawyer* 28, 30; O Pasparakis, 'Canada: Security for Lending-Purchase Money Security Interest' *J Int'l Bank L Regul* 23.

<sup>47</sup> L Gullifer (ed), *Goode on Legal Problems of Credit and Security*, 4<sup>th</sup> edn (London, Sweet & Maxwell 2008) 5-62 – 5-64.

<sup>48</sup> Jackson and Kronman (n 1) 1167.

<sup>49</sup> See R Hakes, 'According Purchase Money Status Proper Priority' (1993) 72 *Or L Rev* 323; K Meyer, 'A Primer on Purchase Money Security Interests Under Revised Article 9 of the Uniform Commercial Code' (2001) 50 *U Kan L Rev* 143; H Flechtner, 'Inflatable Liens and Like Phenomena: Converting Unsecured Debt Under UCC Article 9 and the Bankruptcy Code' (1987) 72 *Cornell L Rev* 696.

<sup>50</sup> N Hansford, 'The Purchase Money Security Interest in Inventory Versus the After-Acquired Property Interest – A 'No Win' Situation' (1986) 20 *U Rich L Rev* 135, 240-242; McCormack (n 6) 7-59.

<sup>51</sup> Gullifer (n 47) 5-63.

money security interest to its subsequent creditor.<sup>52</sup> The PMSI is usually linked to a specifically identified object which is acquired by the debtor either on credit or with the help of the money provided by the subsequent creditor.<sup>53</sup> The PMSI allows the subsequent creditor to overcome the priority of the first-in-time creditor and to assert its own priority over the object which was acquired by the debtor with the loan provided by it. Since the primary purpose of the PMSI is to avoid the effects of the after-acquired property clause, it may be concluded that the need for it will only arise if such a clause can, in principle, be incorporated into the security agreement.<sup>54</sup> The creation and registration of the security and other international interests under the Convention require unique identification of the objects. This means that it is unlikely that the after-acquired property clause relating to future unidentified objects can be incorporated into the agreement creating the international interest and registered in the International Registry. Consequently, there will, generally, be no need for the PMSI under the Convention and, for this reason the latter does not provide any special super-priority to such a device.<sup>55</sup> The prior creditor's security interest will be confined to the uniquely identified objects listed in its registration information and any new

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<sup>52</sup> For example, s. 9-324 of Article 9 UCC provides that PMSI has priority over a prior conflicting security interest even if the PMSI is later perfected. S. 9-324(a) states that to assert priority over a prior security interest the PMSI holder has to perfect within 20 days after the debtor receives possession. The status of the PMSI under English law is less clear. The cases dealing with the PMSI situation are primarily concerned with prior secured creditor with a security in present and future property of the debtor and a mortgagee providing the debtor with a loan for the purchase of land. Cases decided before *Abbey National Building Society v Cann* [1991] A.C. 56 dealt with the priority conflict between the secured creditors by analyzing whether there was a moment in time (*scintilla temporis*) when the debtor received an unencumbered title to the property during which time the first security interest could attach to it. If no such time existed, then the first secured creditor's security attached to the already encumbered title of the debtor and the second secured creditor won. *Abbey National Building Society v Cann* [1991] A.C. 56 rejected the *scintilla temporis* analysis and emphasized the need to look at the commercial reality of such cases: the PMSI creditor won as the acquisition of property and the mortgage money used to finance it were bound together so that the debtor never received an unencumbered title to the land. For the discussion of the PMSI problems in the context of English law see G McCormack, 'Charges and Priorities – The Death of the *Scintilla Temporis* Doctrine' (1991) *Company Lawyer* 11; C Davis and H Bennett, 'Fixtures, Purchase Money Security Interests and Dispositions of Interests in Land' 1994 *LQR* 448; J Jeremie, 'Gone in an Instant – the Death of '*Scintilla Temporis*' and the Growth of a Purchase-Money Security Interest in Real Property Law' 1994 *JBL* 363; J D Lacy, 'Retention of Title, Company Charges and the *Scintilla Temporis* Doctrine' 1994 *Conveyancer and Property Lawyer* 242. See also *Abbey National Building Society v Cann* [1991] A.C. 56; *Re Connolly Bros Ltd* (2) [1912] 2 Ch 25; *Wilson v Kelland* [1910] 2 Ch 25; *Church of England Building Society v Piskor* [1954] Ch 553.

<sup>53</sup> White and Summers (n 11) 847.

<sup>54</sup> D Carlson, 'Purchase Money under the Uniform Commercial Code' (1993) 29 *Idaho L Rev* 793, 795.

<sup>55</sup> Goode (n 4) 66.

aircraft objects acquired by the debtor will not be automatically covered by the registered security. If the prior creditor agrees to provide finance for the acquisition of the new aircraft object, the parties will have to register a new security interest in relation to such object. If, on the other hand, the finance is provided by a different creditor, there will be nothing to prevent the parties from registering a security interest in its favour which will allow it to assert priority in relation to this object.

b) The possibility of the PMSI under the Convention

Although the previous section suggests that there is no possibility for the creation of the PMSI under the Convention, there may be a need for a variation of such a security in some limited circumstances. Consider the following example. SC1 finances the acquisition by the debtor of a uniquely identified airframe and two aircraft engines and duly registers its security interest in these objects in the International Registry. A year later, a computer system installed on the airframe as well as the modules of the aircraft engines need replacement. Assume that the computer system is easily detachable from the airframe and does not lose its identity once it is installed on it. The situation with the modules is less clear as once they are installed on the engines, it may be difficult to distinguish which module belongs to a particular manufacturer. While SC1 refuses to provide finance to the debtor for the purchase of the necessary replacements, an aircraft manufacturer (L) is willing to lease them to the debtor. Since computer systems as well as engine modules do not constitute aircraft objects under the Convention, L is unable to register its interest in them in the International Registry and registers its interest in these items as a secured creditor in a national registry. On the debtor's default SC1 wants to take possession and sell the airframe and the two engines. SC1 considers the computer system and the modules as parts of the airframe and the engines and claims that its security automatically covers these items as they do not represent separate aircraft objects for the purposes of the Convention. If SC1 is successful in its claim, it would achieve a similar result as a creditor with an after-acquired property clause in its security agreement.

Admittedly, SC1 does not purport to cover any newly acquired aircraft objects, as defined by the Convention, by its existing security interest. But the

effect would be similar: it would allow SC1 to join to its security new items the acquisition of which was financed by another creditor. To avoid this result and to allow L to retain its interest in such items, the Convention states that it does not affect the rights of a person in an item, other than an object, held prior to its installation on the object if under the applicable law those rights continue to exist.<sup>56</sup> This means that whether L will be able to retain its pre-existing rights in these items will depend on how such rights are treated under the applicable domestic law. For example, if a computer system, which is easily detachable and does not lose its identity on installation or removal from the object, is treated as a separate item in which rights and interests can be created, then L may be able to retain its pre-existing interest in it. In this case, SC1 will claim priority in the airframe and the engines and L will be able to retain its priority in relation to the computer system. This outcome will have the effect of a PMSI under the Convention as the second-in-time holder of a non-registrable interest in an item who financed its acquisition (L) will be able to take priority over the first-in-time holder of a registered security interest (SC1). If this analysis is correct then it would mean that PMSI is possible under the Convention in limited circumstances and that it constitutes an exception to the general priority rule that registered interest has priority over the unregistered one. In this case it may be regrettable that the Convention does not deal with this issue expressly and delegates it to the applicable domestic law. If the Convention provided for the registration of rights and interests in items and not only objects, it would be possible to design a clearer rule with respect to rights and interests in such items. On the other hand, it may well be the case that not all such items and spare parts are capable of unique identification and their registration in the International Registry would not be possible for that reason. Since the issue is delegated to the applicable domestic law, the results may differ in each case. For example, the issue of modules installed on the aircraft engines may be resolved differently by various legal systems. If these items are treated as an accessory to the main object which is capable of being separately owned, then L may be able to retain its rights in them.

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<sup>56</sup> Art 29(7)(a).

If, on the other hand, the modules are considered as part of the object by the applicable domestic law, then L's interest will become vested in SC1.<sup>57</sup>

### 3. Exceptions to the general rule of priority

#### 3.1 General

Many legal systems resolve priority conflicts between competing interests based on some form of a first-in-time rule. The priorities may be determined on a first-in-time of creation or registration basis, but the underlying idea of these rules is usually the same: once the debtor grants a security interest in its object to SC1, it cannot grant the same interest to SC2. In other words, one cannot give what one has not got.<sup>58</sup> All that the debtor will be able to give to SC2 is whatever is left after the disposition to SC1, namely the interest in the object of the debtor encumbered by security interest of the previous creditor. This explains why the interest of SC2 is, generally, subjected to the interest of SC1. When priorities are determined by the order of registration, the holders of competing interests may rely on the registration system: they can search the registry in order to assess their potential priority position among other creditors. Once the interest is registered, its holder may expect other searching parties to recognise its priority. This is why exceptions to the general rule are best kept to a minimum and the ones which are accepted require justification. The Convention provides several exceptions to the first-to-register rule. Some of these exceptions, such as the one relating to an outright buyer and the variation agreements, may be justified on the ground that they are extremely common and considered to be important by many legal systems. Others, such as the one relating to the pre-existing rights and interests, are not likely to arise frequently and therefore do not affect the application of the general rule to any great extent.

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<sup>57</sup> This point can be illustrated by *Hendy Lennox (Industrial Engines) Ltd v Grahame Puttick Ltd* [1984] W.L.R. 485. In this case engines which were incorporated into the generators and sold subject to a retention of title clause could be detached from the generators. This meant that the retention of title clause was effective.

<sup>58</sup> This principle is also known as *nemo dat quod non habet*. See Beale, Bridge, Gullifer, Lomnicka (n 13) 417.

#### a) Outright buyer

The first exception to the rule that even an unregistrable interest is postponed to the registered interest relates to the position of an outright buyer. The Convention does not, generally, govern outright sales of objects as it is primarily concerned with the interests arising out of secured credit, conditional sale and lease.<sup>59</sup> The case of a purchase by an outright buyer is considered to be so common and important in many legal systems<sup>60</sup> that the Convention provides a special rule giving priority to the outright buyer in certain circumstances.<sup>61</sup> Article 29(3)(a) states that the buyer of an object acquires its interest in it subject to an interest registered at the time of its acquisition of that interest. This rule can hardly be considered as an exception to the general rule of priority as it postpones the unregistered interest of the buyer to a prior registered interest. If D grants a security interest in a locomotive to SC1, who immediately registers its interest, and then D sells the object to the buyer, the buyer will take subject to the registered interest of SC1 which is in line with the general rule of priority. This also means that the buyer whose interest is not registrable in the International Registry and who, for this reason, may not be expected to search the registry, will have to do so before making the decision as to the acquisition of the object or risk subordination to a prior registered interest.<sup>62</sup> The justification for this rule may be found in the nature of the objects governed by the Convention: since these objects

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<sup>59</sup> Outright sale of aircraft objects is an exception to this rule. See Art III of the Aircraft Protocol.

<sup>60</sup> For example, the general rule that the security interest is effective against purchasers of the collateral stated in s 9-201(a) of Article 9 UCC is subject to a number of exceptions. Most importantly, s 9-320(a) of Article 9 provides that a buyer in ordinary course of business takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence. In order to acquire the object free of the perfected security interest, the person must be a buyer in the ordinary course of business giving new value and purchasing from the person who is in the business of selling goods of that kind. The purchaser must also buy in good faith and without knowledge that it is buying in violation of the terms of the security agreement although it may know of the existence of security. Finally, the competing security interest must be created by the buyer's seller. So if the seller itself bought it from another person who also created a security interest in that object, the buyer will not be protected against that secured creditor. See *Martin Bros. Implement Co. v Diepholz*, 109 Ill. App. 3d 283, 64 Ill. Dec. 768, 440 N.E. 2d 320 34 UCC 1749(1982); *O. M. Scott Credit Corp. v Apex, Inc.*, 97 R. I. 442, 198 A. 2d 673, 2 UCC 92(1964); *Hempstead Bank v Andy's Car Rental System, Inc* 35 A.D. 2d 35, 312 N.Y.S. 2d 317, 7 UCC 932 (1972). See also White and Summers (n 9) 865-869; J Britton, 'Consignments, Landlord's Lien, Purchase Money Security Interests and Rights of Transferees of Collateral' (2000) 25 Oklah City U L Rev 213, 227.

<sup>61</sup> Goode (n 4) 225.

<sup>62</sup> Under English law, the buyer in the ordinary course of business is not expected to search the registry as its own interest cannot be registered there. See G McCormack, 'Priority of Charges and Registration' (1994) JBL 587, 598.

are of high value, it may be suggested that the buyer would not expect them to be unencumbered and would prefer to search the registry before the acquisition in any event.

Article 29(3)(b) stipulates that the buyer of an object acquires its interest in it free from an unregistered interest even if it has actual knowledge of such an interest.<sup>63</sup> Although the Convention does not govern the priority between unregistered interests, in this case, as between an unregistered international interest and the unregistered interest of the buyer, the interest of the latter will have priority. This rule is a true exception to the general rule of priority, but the seller must necessarily have the power to dispose of the object for it to operate.<sup>64</sup> For example, if D grants a security interest in the train wagon to SC1 on 1 May (who registers on 20 May) and sells the same object to B on 5 May, B will take free of the unregistered interest of SC1 even if it had actual knowledge of its interest and even if SC1's interest is later registered. This way, the buyer can rely on the information found on the register which helps in maintaining the integrity of the system.

Finally, Article 29(3) does not apply to aircraft objects because Aircraft Protocol renders outright sale of such objects registrable in the International Registry.<sup>65</sup> Accordingly, priority between international interests and the interest of the buyer of an aircraft object will depend on the order of registration of these interests.

#### b) Conditional buyer and lessee<sup>66</sup>

The second exception to the general rule of priority is designed to protect non-registrable interests of a conditional buyer and lessee against the creditor of their

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<sup>63</sup> The position of the buyer under English law will depend on several factors. When assets which are comprised in a floating charge are disposed of absolutely, the buyer will take free of the charge if the disposition was in the ordinary course of the debtor's business. The width of authorisation given by the chargee is usually wide, but if the disposition is outside of the permission, the buyer will take subject to the charge, unless some other exception to the first-in-time of creation rule applies. Since the charge is equitable, the buyer taking legal title to the goods will take priority if it has no notice of the previous interest. Conversely, when the assets are subject to the fixed charge, the chargor is not, generally, authorised to dispose of them and the buyer may take subject to the charge, unless an exception to the general rule may be found. See Beale, Bridge, Gullifer, Lomnicka (n 13) 445-455.

<sup>64</sup> Goode (n 4) 225. For a more detailed discussion see Chapter II.

<sup>65</sup> Art III of the Aircraft Protocol.

<sup>66</sup> See Chapter II for a more detailed discussion of the position of the conditional buyer and lessee.

seller or lessor. If the conditional seller or lessor registers its interest in the object before its creditor, then the interest of the conditional buyer or lessee will prevail over the registered interest of the creditor.<sup>67</sup> This will be the case even if the conditional buyer or lessee had actual knowledge of the unregistered interest of the creditor.<sup>68</sup> The protection of the conditional buyer or lessee depends on the status of the registered interest of conditional seller or lessor: should such interest be discharged, the protection will be lifted and the interest of the conditional buyer and lessee will be subordinated to the registered interest of the creditor.

c) Non-registrable rights and interests arising as a result of declaration under Article 39<sup>69</sup>

A Contracting State can make a declaration under Article 39 of the Convention which may have the effect of promoting certain non-registrable non-consensual rights or interests ahead of registered international interests. Examples of rights under Article 39 include non-consensual liens of repairers for repairs to objects in their possession or non-consensual liens on aircraft for unpaid navigation, fuel, maintenance and other charges.<sup>70</sup> In order to be covered by a declaration, such non-consensual rights and interests must have priority without registration over an interest that is considered as an equivalent of an international interest under the law of the Contracting State.<sup>71</sup> For instance, the debtor may grant a security interest in an aircraft engine to the secured creditor who registers its interest in the International Registry. It may later transpire that the object was delivered for repairs to A. Provided that the interest held by A in the engine is one of such non-consensual rights and interests in relation to which the declaration under Article 39 was made, the secured creditor will be subordinated to the interest of the repairer. In other words, the second-in-time and unregistrable interest of A will take priority over the first-in-time registered interest of the secured creditor.<sup>72</sup>

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<sup>67</sup> Art 29(4)(b).

<sup>68</sup> Art 29(4)(b).

<sup>69</sup> For a more detailed discussion of non-consensual non-registrable rights and interests see Chapter III.

<sup>70</sup> Goode (n 4) 257.

<sup>71</sup> Art 39(1)(a).

<sup>72</sup> The fact that such liens cannot always be easily revealed and yet take in priority over registered security interests may explain certain judicial hostility towards them which was evident in some



#### d) Pre-existing rights and interests

The next exception relates to the rights and interests which were created before the Convention came into force or before a State became a Contracting State. There was some debate as to whether the Convention should apply to pre-existing rights and interests and if so, whether they should require re-perfection in the International Registry in order to be effective. On one view, re-perfection was not necessary. On another view, it was thought that if the pre-existing rights and interests were not required to be registered in the International Registry, then the holders of the post-Convention interests may be subordinated to pre-Convention rights and interests the existence of which they could not discover.<sup>73</sup> Article 60 of the Convention offers a compromise solution to this debate. It firstly establishes a general rule that the Convention does not apply to pre-existing rights and interests and that they simply retain the priority they enjoyed under the applicable law before the Convention became effective.<sup>74</sup> The holder of such a right or interest cannot rely on the rules of priority, enforce any remedies or invoke any other provisions of the Convention and the matter should be resolved by the applicable law.<sup>75</sup> The date when the Convention becomes effective for this purpose is either when it comes into force or when the State in which the debtor is located becomes a Contracting State.<sup>76</sup> The Convention becomes effective in relation to any particular category of objects when the relevant Protocol comes into force.<sup>77</sup>

The general rule that the Convention does not apply to pre-existing rights and interests may be modified by the declaration which a Contracting State can make under Article 60(3).<sup>78</sup> The Contracting State must indicate in its declaration a date, not earlier than three years after the declaration becomes effective, when the Convention and the Protocol will become applicable to the pre-existing rights

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earlier cases under English law. See A Bell, 'The Priority of General Liens' (1986) *Company Lawyer* 164.

<sup>73</sup> R Goode, 'The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing' (2003) 36 *UCC L J* 2 Art 1.

<sup>74</sup> Art 60(1).

<sup>75</sup> Goode (n 4) 288.

<sup>76</sup> Art 60(2)(a).

<sup>77</sup> Art 49(1). To date the only Protocol which is in force is that relating to aircraft objects. It is effective as of 1 March 2006 which is also the date when the Convention in relation to aircraft objects became effective.

<sup>78</sup> Once the declaration is made it cannot be withdrawn or modified. See Art 57(1) and 58(1).

and interests.<sup>79</sup> For the Convention and the declaration to apply, the pre-existing right or interest must arise out of the agreement which was concluded when the debtor was situated in the State.<sup>80</sup> So if the debtor's centre of administration, place of business or habitual residence is located in the State<sup>81</sup> which has not made a declaration and the debtor grants a security interest to a secured creditor in an airframe, the Convention will not apply to such a security interest. The situation may change if the State becomes a Contracting State and decides to make a declaration that the Convention will apply to pre-existing rights and interests in three years after the declaration becomes effective. If the secured creditor re-perfects its interest by registering it in the International Registry then, once the period specified in the declaration lapses, the Convention will apply to it. The purpose of the specified period is to provide the holders of pre-existing rights and interests with sufficient time during which they can register their interests in the International Registry.<sup>82</sup> The requirement as to specified period also helps to ensure that the holders of the post-Convention interests will not be subordinated to pre-Convention rights and interests the existence of which they could not discover.<sup>83</sup> Finally, when the Convention and the Protocol will become applicable under the declaration, they will only apply for the purpose of determining the order of priority, including the protection of any existing priority of the pre-existing right or interest.<sup>84</sup> It is not clear why the Convention does not allow the holders of the pre-existing rights and interests to invoke the provisions relating to the remedies. The explanation may be found in the purpose of the declaration: it was aimed at establishing a cutting-off point after which the pre-existing rights and interests would lose their priority, not to extend the Convention to them.<sup>85</sup>

How can a pre-existing right or interest constitute an exception to the general rule of priority that a registered interest prevails over the subsequently registered and unregistered interest? Consider the following example. The

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<sup>79</sup> Art 60(3). Art XXVI of the Luxembourg Protocol states that the date which should be indicated in the declaration must not be earlier than three and later than 10 years. See H Rosen, 'The Luxembourg Rail Protocol: A Major Advance for the Railway Industry' (2007) *Unif L Rev* 427, 444.

<sup>80</sup> Art 60(3).

<sup>81</sup> Art 60(2)(b) defines the location of the debtor for these purposes.

<sup>82</sup> Goode (n 4) 289.

<sup>83</sup> *Ibid* 289.

<sup>84</sup> Art 60(3).

<sup>85</sup> Rosen (n 79) 445.

debtor<sup>86</sup> grants security interests in a uniquely identified airframe to secured creditor 1 and secured creditor 2 for the purpose of securing the repayment of the loan which it needed in order to purchase the airframe. Both SC1 and SC2 registered their interests in due course in the national registry where priority is determined by the order of registration. A year later, the State has become a Contracting State and made a declaration under Article 60(3) of the Convention. The declaration specified that the Convention should apply to pre-existing rights and interests on expiration of a three year period from the date of the declaration. A year later, the debtor grants SC3 a security interest in the same airframe who, after searching the registry and obtaining a clear search, assumes that it will be the first holder of a registered security in the airframe and immediately registers its interest in the International Registry. Six months later, SC2 registers its interest in the International Registry and three years later SC1 also registers its security interest there. SC2's security interest, although registered later in the International Registry, will have priority over SC3's interest because the declaration protects pre-Convention priority of the pre-existing interest. In other words, the registered interest of SC3 will be postponed to the later registered interest of SC2, which amounts to an exception to the rule that a registered interest has priority over the subsequently registered interest. Had SC1 registered its interest within the specified period, it too would have had priority over SC2 and SC3. Since SC1 registered outside of the specified period, it lost its priority to other creditors of the debtor. It should be noted that although Article 60(3) may create an exception to the general rule of priority, it seems unlikely that it will become of frequent use: to date, none of the Contracting States has made a declaration protecting pre-existing rights and interests.

Finally, Article 60 gives rise to a question, which may have relevance to the order of priority, but to which the Convention does not seem to provide a clear answer. Another hypothetical situation may help to illustrate the point. Consider a debtor who is situated in a State and grants a security interest in an airframe to SC1. SC1 registers its interest in the national registry. A year later, the State becomes a Contracting State, but does not make a declaration under Article 60(3). The debtor grants SC2 and SC3 security interests in the same airframe and they

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<sup>86</sup> Assume that the debtor is situated in a State as required by Art 60(2)(b).

register these interests in that order in the International Registry. Clearly, the interests of SC2 and SC3 will be governed by the Convention and priority between them will be determined by the order of registration. What is less clear is how will priority dispute between these post-Convention interests and the pre-Convention interest of SC1 be determined? On the one hand, it may be argued that since the Contracting State has not made the declaration under Article 60(3), Article 29(1) and the Convention itself do not apply and the matter should be resolved by the applicable law.<sup>87</sup> This must be correct in relation to the pre-existing interest of SC1 as Article 60(1) states that such rights and interests are not governed by the Convention. But does this mean that the post-Convention registered interests of SC2 and SC3 automatically gain priority over SC1 under the Convention or should their position also be considered under the applicable law? The Official Commentary seems to suggest that the priority between competing interests under such circumstances should be determined by the applicable law.<sup>88</sup> But, if this is correct, then SC2 and SC3 could be deprived of the benefits of their registrations under the Convention: if their interests were not registered in the same national registry as that of SC1, their priority may be postponed to the interest of SC1 under the applicable law. This is essentially the question of choice between different legal regimes and the Convention does not seem to provide a clear answer as to which of these regimes should apply to resolve the issue. This position may lead to unsatisfactory results where the outcome of priority conflicts between registered international interests and pre-existing interests arising in Contracting States which made no declaration under Article 60(3) will be resolved on a case by case basis.

#### e) Variation agreements

In conformity with the principle of party autonomy underlying the Convention, the general rule that the registered interest has priority over the subsequently registered and unregistered interests may be varied by an agreement changing the order of priorities between competing creditors.<sup>89</sup> As a result of the variation or

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<sup>87</sup> This is the position expressed in the Official Commentary. See Goode (n 4) 291, Illustration 44.

<sup>88</sup> Goode (n 4) 291, Illustration 44.

<sup>89</sup> Art 29(5).

subordination agreement, a registered interest may be postponed to a subsequently registered interest and the agreement to this effect may be registered in the International Registry.<sup>90</sup> A subordination agreement is also possible between a registered and an unregistered interest which would ordinarily enjoy priority over the registered interest. For example, if a lessor registers its interest before its secured creditor, the lessee, whose interest is not registrable, will have priority over the registered interest of the secured creditor. The parties may, however, enter into a registered subordination agreement changing this order of priority.

The Convention does not state whether the holders of competing interests should obtain consent of the debtor in order to create a valid subordination agreement. But it may be suggested that since the Convention is silent in relation to this issue, obtaining consent should not be a prerequisite for a valid subordination agreement. In contrast, in relation to partial assignments of associated rights and interests, the Convention expressly states that such agreements should not be concluded if they adversely affect the debtor and if its consent was not obtained.<sup>91</sup> In addition, it may be suggested that since the debtor is obliged to satisfy claims of all secured creditors and holders of other international interests, the order in which this will be accomplished should be of no relevance to it.<sup>92</sup>

The registration of a subordination agreement may be of particular importance to the assignee of the subordinated interest, because unless it is registered, the assignee may presume that it steps into the shoes of a senior creditor.<sup>93</sup> For this reason, the Convention provides that unless a subordination agreement is registered, the assignee will not be bound by it.<sup>94</sup> So if SC1 and SC2, who registered their interests in that order, enter into a subordination agreement and SC1 later decides to assign its interest together with associated rights to A, the latter will take priority over SC2 if the subordination agreement was not

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<sup>90</sup> Art 16(1)(e). Such agreements are frequently used when the debtor needs new finance and the prior creditor is unable or not willing to provide it. The prior creditor may agree to subordinate its claim to a subsequent creditor if the latter provides finance to the debtor which may increase the prior creditor's chances of obtaining the repayment. See M Bridge, 'Failed Contracts, Subrogation and Unjust Enrichment' (1998) JBL 323, 324.

<sup>91</sup> Art 31(2).

<sup>92</sup> This is the approach taken by English law. See *Cheah v Equiticorp Finance Group Ltd* [1992] 1 A.C. 472; R Nolan, 'Less Equal than Others' [1995] JBL 485.

<sup>93</sup> Goode (n 4) 227.

<sup>94</sup> Art 29(5).

registered. Conversely, if SC2 registers the subordination agreement before the assignment occurs, A's interest will be postponed to that of SC2.

#### 4. Effects of insolvency

##### 4.1 General

It is often said that the true value of a security or an international interest lies in its ability to retain its priority and survive the insolvency of the debtor.<sup>95</sup> Although Article 30, dealing with the effects of insolvency on international interests, does not contain any rules of priority, it may have an effect on the order of priority between competing interests under the Convention. Before insolvency, the creditor may be certain that the loan will be repaid sooner or later. But when insolvency intervenes, the debtor will not usually have enough assets to satisfy all obligations it owes to its creditors. This means that in the competition between various holders of international interests in debtor's assets those who did not comply with the requirements of the Convention, i.e. failed to register their interests before commencement of the insolvency proceedings, will lose their priority. As a result, a subsequent secured creditor may be promoted in their place which will change the original order of priority. Even if the creditor complies with the requirements of the Convention, the insolvency administrator may, in certain circumstances, avoid the security interest as a preference or a fraudulent transfer which will cost the secured creditor the loss of its privileged position.

This part of the Chapter will consider how the priority of the security and other international interests may be preserved in the case of the debtor's insolvency and what techniques may be used by an insolvency administrator in an attempt to avoid such interests.

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<sup>95</sup> White and Summers (n 9) 813; Gullifer (n 47) 5-01.

#### 4.1.1 Effectiveness of the international interests

##### a) Registration as a prerequisite of effectiveness

The Convention expressly states that the international interest which was registered before the commencement of the insolvency proceedings against the debtor remains effective in the debtor's insolvency.<sup>96</sup> Therefore, registration not only determines the order of priority, but is also vital in ensuring that the international interest remains effective and survives the insolvency of the debtor. It is implicit in the Convention that to provide the international interest with the shield of effectiveness, the registration itself must be valid.<sup>97</sup> So if the registration relates to a prospective international interest which never matured into an actual interest because, for example, the debtor did not obtain the power to dispose of the object, the mere fact of registration will not render such an interest effective in the case of the debtor's insolvency.

What if the registration of the prospective international interest is effected before the commencement of the insolvency proceedings, but the debtor only obtains power to dispose of the object (converting the prospective interest into an actual one) after such proceedings are started? Both priority and effectiveness of the international interests relate back to the date of registration and on this basis it may be suggested that, unless such an interest can be set aside by the applicable domestic law as a preference or a fraudulent transfer, it should remain effective under the Convention. So too, failure to renew the existing registration will make the interest ineffective in the insolvency proceedings. For example, if the secured creditor registers the security interest in the debtor's airframe for five years which expire on 7 June and does not renew the registration before that date, the registration will be discharged and the interest will lose its effectiveness in the insolvency proceedings starting next month. At the same time, if the registration is renewed before the expiration of the original one, then the interest will probably remain effective even if the renewal was affected only hours before the commencement of the insolvency proceedings. This should be the case because

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<sup>96</sup> Art 30(1).

<sup>97</sup> The registration must be affected in conformity with the Convention. See Art 30(1). For more details see Chapter III.

renewal of the registration does not amount to a fresh registration: its only effect is to ensure the continuance of the existing registration. Consequently, if the original registration cannot be set aside as a preference or a fraudulent transfer under the applicable law, its renewal should also be able to survive the debtor's insolvency. Validity of registration may also be impaired if other requirements of the Convention were not met. For example, if the debtor was not situated in the Contracting State at the time when the agreement creating or providing for the international interest was concluded, the registration of such an international interest may not be effective and it may fail the test of insolvency.

b) *The meaning of 'effectiveness'*

The Convention states that if the international interest is registered in the International Registry, it will be effective in the insolvency proceedings against the debtor.<sup>98</sup> The meaning of the term 'effectiveness' is not expressly defined by the Convention, but it is suggested that it means that the proprietary nature of the international interest will be recognised and that it will have priority over unsecured creditors of the debtor.<sup>99</sup> It is also suggested that since the international interest is the autonomous creature of the Convention, its effectiveness must mean that it should not be subordinated to the interests of other claimants to which its equivalents under the applicable domestic law would ordinarily be subordinated. So a holder of an international interest by way of a floating charge should not be expected to set aside a prescribed part of its realisations for the benefit of the unsecured creditors,<sup>100</sup> nor should it be subordinated to the claims of the preferential creditors even if this would be required under the applicable domestic law.<sup>101</sup> It would also seem that the expenses of insolvency proceedings which under the applicable law would be payable out of the assets comprised in a floating charge should not automatically be payable from the assets subject to the

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<sup>98</sup> Art 30(1).

<sup>99</sup> Goode (n 4) 231. For the discussion on whether the international interest is proprietary in nature see Chapter I.

<sup>100</sup> As would be the case under English Insolvency Act 1986 (Prescribed Part). Order 2003 SI 2003/2097.

<sup>101</sup> As would be the case under English law. See Insolvency Act 1986, s 175(2)(b) and para. 65(2)Sch.B1 applying s 175 to a distribution by an administrator.



international interest.<sup>102</sup> Finally, provided that the international interest is registered it will be effective even if it would otherwise be void under the applicable domestic law.<sup>103</sup> For example, under English law a mortgage over an airframe is required to be registered both in a specialist registry and as a company charge within 21 days of creation. If the mortgage is not so registered it will be void under the domestic law, but remain effective under the Convention provided that it was registered in the International Registry.

### c) Commencement of insolvency proceedings

The Convention provides for a cutting off point after which the registration of the international interest will not render it effective in the case of the debtor's insolvency. It states that the international interest will only be effective if registered prior to the commencement of the insolvency proceedings<sup>104</sup> which means the time at which the insolvency proceedings are deemed to commence under the applicable insolvency law.<sup>105</sup> For example, under the US bankruptcy law, a transfer of property in a bankruptcy estate can be avoided if it occurred after the commencement of the bankruptcy proceedings and was not authorised by the Bankruptcy Court or the Bankruptcy Code.<sup>106</sup> The bankruptcy proceedings are deemed to start at the time when the petition is filed.<sup>107</sup> In one case the question arose as to whether the transfer occurred before the debtor filed its petition under Chapter 11 (when the creditor received the cheque from it) or after that (when the

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<sup>102</sup> For example, English law provides that expenses of administration are payable from the assets comprised in the floating charge in priority to the holder of such a charge. See Insolvency Act 1986, para. 99(3) Sch. B1. Likewise, the expenses of the liquidation are also payable from the assets subject to the floating charge. See s 176ZA Insolvency Act 1986 introduced by s. 1282 Companies Act 2006 which reversed the position under *Buchler v Talbot* [2004] UKHL 9 [2004] 2 A.C. 298.

<sup>103</sup> Goode (n 4) 231. This follows from the international and autonomous nature of the international interest which is the creation of the Convention and not of the applicable domestic law. For more details see Chapter II.

<sup>104</sup> Art 30(1).

<sup>105</sup> Art 1(d). For example, under French law the 'suspect period' begins at the time when the insolvent debtor becomes unable to make payments as they become due. This period, if determined by a court, may deem to start as early as eighteen months prior to the judgment opening the insolvency proceedings. The French Commercial Code states that transactions concluded during the suspect period are either automatically void or may be avoided at the discretion of the court. See M Gdanski, 'Taking Security in France' in Bridge and Stevens (n 5) 82.

<sup>106</sup> *In re Paxton*, 440 F. 3d 233, 236(5<sup>th</sup> Cir. 2006).

<sup>107</sup> *In Re Contractor Technology, Ltd*, not reported in F. Supp. 2d, 2006 WL 1118039 (S.D.Tex.), 56 Collier Bankr. Cas. 2d 191, Bankruptcy case No. 05-37623-H1-7.

cheque was cashed). It was held that the transfer occurred when the cheque was honored which was after the petition was filed and, consequently, after the bankruptcy proceedings started. Consequently, the transfer could be avoided.<sup>108</sup> The cutting off point, i.e. the commencement of the insolvency proceedings, which is marked by the filing of the petition, may encourage prompt registration of international interests and provide the creditor with certainty in that it will have a date upon which the parties to the transfer can rely in their transactions.

Another question which is not expressly governed by the Convention and should, probably, be delegated to the applicable law is how long before the commencement of the insolvency proceedings should the registration be made in order for the international interest to be effective. For example, if the petition is filed on 9 June and the grant and registration of a security interest in an airframe was made on 7 June, will the registration of the international interest be effective in the insolvency proceedings? The answer to this question may depend on the policies underpinning the powers of insolvency administrator to set aside security interests and of setting a certain event as the main reference point for that. One of the objectives of stipulating a cutting off point, such as the start of the insolvency proceedings seems to be the avoidance of secret security interests.<sup>109</sup> If security interests were allowed to be registered after the insolvency proceedings started, secured creditors could be persuaded to keep the transaction unpublicised until the very last moment which would allow the debtor to encumber the assets more heavily.<sup>110</sup> For this reason, security interests registered after the commencement of insolvency proceedings are not, generally, effective.

But if the security interest is filed immediately before such proceedings are started, the effectiveness of the international interest can be preserved. For example, under the US law, if a trustee in bankruptcy acts as a hypothetical lien creditor, it will prevail over most secured creditors if their security interests were not perfected before the commencement of the proceedings.<sup>111</sup> But perfection only a few minutes before the commencement of the proceedings can save the security interest.<sup>112</sup> The trustee in bankruptcy can, of course, attempt to avoid the security

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<sup>108</sup> Ibid.

<sup>109</sup> White and Summers (n 9) 815.

<sup>110</sup> Ibid 819.

<sup>111</sup> S 9-317(a)(2) of Article 9 UCC.

<sup>112</sup> White and Summers (n 9) 818.

as a preference or as a fraudulent transfer. So if the transfer of the debtor's property was made within 90 days before the original filing of the petition, and provided that other necessary conditions were met, the trustee will be able to avoid even a perfected security interest as a preference.<sup>113</sup> For example, in *Barnhill v Johnson* where the question, as in the above case, was whether the day of the transfer was when the cheque was received by the creditor or cashed at the bank, it was held that the day of the transfer was when the cheque was cashed. As this day was within 90 days before the date of the filing of the petition (and the commencement of the proceedings), the trustee in bankruptcy was able to set the transaction aside.<sup>114</sup> Conversely, if the transfer occurred more than 90 days before the petition was filed, the security interest cannot be avoided as a preference.<sup>115</sup>

d) Effectiveness in insolvency: the rule of validation, not invalidation

As noted above, Article 30(1) provides that an international interest is effective if, prior to the commencement of the insolvency proceedings, that interest was registered in conformity with the Convention. Article 30(2) then states that 'nothing in this Article impairs the effectiveness of an international interest in the insolvency proceedings where that interest is effective under the applicable law'. The meaning of Article 30(2) may not be immediately clear. On one reading, it may be understood as meaning that an international interest which is not registered in the International Registry may still be effective in insolvency proceedings.<sup>116</sup> If this is correct, it would seem to negate the meaning of Article 30(1) that the international interest is effective only if registered as required by the Convention as well as the meaning of Article 29(1) that an unregistered interest (even if it is not registrable) is postponed to a registered one.

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<sup>113</sup> The 90 days should be counted backwards from the date of filing rather than forward from the date of alleged transfer. See *In Matter of Nelson, Co.*, 959 F.2d 1269, 117 A.L.R. Fed. 751, 60 USLW 2606, 26 Collier Bankr. Cas. 2d 979, Bankr. L. Rep. P 74, 518; *In re J.A.S. Markets, Inc.*, 113 B.R. 193, 23 Collier Bankr. Cas. 2d 116, 20 Bankr. Ct. Dec. 78 United States Bankruptcy Court, W.D. Pennsylvania; *In re Carl Sabler Trucking, Inc.*, 122 B.R. 318, 21 Bankr. Ct. Dec. 273, Bankr. L. Rep. P 73, 749.

<sup>114</sup> 503 U.S. 393, 112 S.Ct. 1386, 118 L.Ed.2d 39, 60USLW4264, 26 Collier Bankr. Cas. 2d 323, 22 Bankr. Ct. Dec. 1218, Bankr. L.Rep. P74, 501, 17 UCC.

<sup>115</sup> *In Re M. J. Sales & Distributing Company, Inc.*, 25 B.R. 608, 7 Collier Bankr. Cas. 2d 884, 9 Bankr. Ct. Dec. 1342 United States Bankruptcy Court, S.D. New York.

<sup>116</sup> Goode (n 4) 231.

On another reading, it may be suggested that what Article 30(2) actually refers to is not the international interest as constituted under the Convention, but its equivalent under the applicable law, i.e. a security interest, retention of title agreement or a lease.<sup>117</sup> This could be the case because Article 30(2) refers to the applicable law in relation to such an interest: first, the interest is called an international interest, and then it is referred to as that interest which is effective under the applicable law. This could mean that Article 30(2) provides that the equivalent of the international interest which is created under the applicable law (and not under the Convention as the international interest) may still be effective in the insolvency proceedings even if not registered in the International Registry. For example, a secured creditor may register its security interest in an airframe both in the International Registry (as an international interest) and in a national registry (as a charge). If, before the commencement of the insolvency proceedings, the registration in the International Registry expires and is not renewed, the international interest will lose its effectiveness under the Convention. This should be the case because Article 30(1) clearly states that an international interest is only effective in insolvency proceedings if registered in conformity with the Convention. Consequently, once the registration lapses, the effectiveness of the international interest will be lost. But the effectiveness of the interest, i.e. of the charge, under the applicable law will not be impaired simply because it is not registered in the International Registry. In other words, the effect of Articles 30(1) and (2) is that while the international interest which is not registered in the International Registry will not be effective under the Convention, its equivalent may still be effective in the insolvency proceedings under the applicable law. So the loss of effectiveness under the Convention does not lead to a complete invalidation of the interest and it may retain its validity under the applicable law, provided that the validity requirements of that law are met. In this sense, it may be said that the rule in Articles 30(1) and (2) is the rule of validation, not invalidation of the international interest or its equivalent.<sup>118</sup> If this analysis is correct, it may make the meaning of Article 30(2) clearer. Its effect is that the validity of interests created under the applicable law will not be disturbed if these

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<sup>117</sup> Ibid 231.

<sup>118</sup> Ibid 231.

interests are not registered in the International Registry.<sup>119</sup> But it may also make Article 30(2) seem unnecessary: the validity of an interest under the applicable law should not be within the scope of the Convention. The fact that an interest which is not effective under the Convention may retain its validity under the applicable law seems self evident just as the fact that an interest which is not valid under the applicable law may be effective under the Convention. The Convention and the applicable law are two separate legal regimes and it is perfectly possible that the same interest may be valid under one of these regimes, but not under another: there seems to be little need to restate that in Article 30(2).

The explanation of the effect of Article 30(2) given in the Official Commentary is also, with respect, unsatisfactory.<sup>120</sup> According to the Commentary, Article 30(2) covers the situation where the insolvency jurisdiction is the jurisdiction of a State which is a Contracting State that adopts a *lex situs* conflict rule. If, at the time of the commencement of proceedings, the asset is situated in a State other than the State where the insolvency proceedings have been started and the interest (the equivalent of an international interest) have been perfected there, but not in the International Registry, it will be treated as perfected in insolvency proceedings.<sup>121</sup> This explanation could mean that an interest which is created and perfected in a non-Contracting State and, as a result, not registered in the International Registry, could still be effective under the Convention, which could not have been intended by its drafters. Alternatively, it could mean that the Convention merely recognises that an interest created in this way may retain its effectiveness under the applicable law, i.e. the law of the State where the insolvency proceedings are held. This is, probably, what was meant by the Commentary as it further states that the insolvency jurisdiction remains entitled to apply any rules of its own insolvency law to avoid such interests.<sup>122</sup> Conversely, with respect to the international interest, the insolvency administrator is confined to the powers of avoidance of the international interests as a preference or as a fraudulent transfer.<sup>123</sup> If this is the case, than Article 30(2), once again, seems redundant as the issue of the effectiveness of an interest arising under another

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<sup>119</sup> Goode (n 4) 232.

<sup>120</sup> Ibid 231-232.

<sup>121</sup> Ibid 232.

<sup>122</sup> Ibid 232.

<sup>123</sup> Art 30(3).

legal regime should be within the scope of the applicable law and not the Convention.

#### 4.1.2 Avoidance of international interests

The Convention preserves the rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors.<sup>124</sup> The insolvency administrator can only set aside or avoid the international interest on the grounds that it amounts to either a preference or a fraudulent transfer and cannot invoke any other grounds which could otherwise apply under the applicable law.<sup>125</sup> For example, if one of the requirements for the creation of a security interest is not met under s. 9-203 of Article 9 UCC, such as that the security agreement is not authenticated by the debtor and the creditor is not in the possession of the collateral, the trustee in bankruptcy should not be able to use this failure in order to set aside the security interest which is created and registered as an international interest under the Convention.<sup>126</sup>

The two grounds selected by the Convention are commonly found in insolvency laws of various jurisdictions.<sup>127</sup> One of the main policies behind these powers of the insolvency administrator seems to be that in the prescribed pre-insolvency period similarly situated creditors should be treated equally by the debtor.<sup>128</sup> The insolvency administrator is usually authorised to set aside transfers made within such a period so as not to allow the debtor to favor one of its creditors at the expense of the others.<sup>129</sup> Another policy behind these powers of the insolvency administrator relates to the prevention of secret security interests.<sup>130</sup> But for the power to strike down a transaction as a preference, the

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<sup>124</sup> Art 30(3)(a).

<sup>125</sup> Goode (n 4) 232.

<sup>126</sup> As would be the case under the US law. S. 541(a) and s. 558 of the Bankruptcy Code allow the trustee in bankruptcy to set aside security interests which are not enforceable against the debtor because of failures in their creation.

<sup>127</sup> R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) 15 Bond L Rev 9, 17.

<sup>128</sup> Under the US law this period amounts to 90 days before the original filing of the petition. See s. 547(b) of the Bankruptcy Code.

<sup>129</sup> See *In Re Dewey Barefoot*, 952 F. 2d 795, 60 USLW 2450, 25 Collier Bankr. Cas. 2d 1719, 22 Bankr.Ct.Dec. 717, Bnkr. L. Rep. P 74, 401, 16 UCC Rep. serv. 2d 417 explaining that one of the purposes of statutory power of avoidance is to ensure that all creditors of the same class will receive the same pro rata share of the debtor's estate.

<sup>130</sup> White and Summers (n 9) 819.

secured creditor could take a security in the debtor's airframe and refrain from registering it until the very start of the insolvency proceedings. The airframe would appear as unencumbered to other creditors of the debtor and the secured creditor's international interest would remain secret until the moment when it is mostly needed to it.

The insolvency rules relating to preferences may allow the insolvency administrator to avoid even registered international interests provided that necessary conditions of the applicable law are met.<sup>131</sup> For example, under the US law, if it can be shown that the debtor paid the debt in the 90 days before the commencement of the insolvency proceedings, such a transfer can be attacked as a preference.<sup>132</sup> If the challenge is successful, the transfers will be recaptured for the benefit of unsecured creditors and the claim of the secured creditor will be postponed to a subsequently registered holder of the international interest. In order to be able to strike the transfer down as a preference the insolvency administrator may also need to show that it was a transfer of the debtor's property.<sup>133</sup> If the secured creditor provides a loan to the debtor to enable it to purchase an aircraft engine and the loan is secured by this object, then if the secured creditor registers its international interest within the 90 days period prior to the commencement of the insolvency proceedings, the transfer may be subject to avoidance as a preference under the US law.<sup>134</sup> This does not necessarily mean that any transfer made within the prescribed period will be set aside as a preference. The international interest can still be saved if one of the exceptions under the applicable law can be applied to an otherwise preferential transfer.<sup>135</sup> So if the

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<sup>131</sup> Ibid 818.

<sup>132</sup> Ibid 818.

<sup>133</sup> The conditions which must be met in order to establish a case for a voidable preference under the US law can be found in s. 547(b) of the Bankruptcy Code. Under this section, the trustee in bankruptcy must prove that there was 1) a transfer; 2) of the debtor's property; 3) to or for the benefit of the creditor; 4) for or on account of an antecedent debt; 5) made while the debtor was insolvent; 6) within 90 days before the original filing of the petition; 7) which enables the creditor to receive more than he would receive under a Chapter 7 liquidation.

<sup>134</sup> If, on the other hand, the loan is secured by a letter of credit issued by the debtor's bank for the benefit of the creditor, the payment under the letter of credit will not be subject to avoidance as a preference as it will not amount to the payment out of debtor's property. This is because under a letter of credit, the payment is made out of the property of the bank, not that of the debtor. See *In Re Leisure Dynamics*, 33 B. R. 171, Bankr. L. Rep. P 69, 405; *In re Subratek Corporation*, 257 B.R. 723, Collier Bankr.Cas. 2d 1223; *In re Clothes*, 35 B.R. 487; The position would be different if the bank took a security interest to ensure the repayment by the debtor under the letter of credit. See *In re Air Conditioning*, 845 F. 2d 293, 18 Collier Bankr. Cas. 2d 973, 17 Bankr. Ct. Dec. 1385, Bankr L. Rep. P 72, 302.

<sup>135</sup> J White and D Israel, 'Preference Conundrums' (1993) 98 Commercial L J 98.

loan was substantially contemporaneous with the perfection of the security interest<sup>136</sup> or the debtor received new value as a result of the transfer to the creditor,<sup>137</sup> then an otherwise preferential transfer can be saved under the applicable insolvency law.

Finally, the Convention does not affect any rules of the insolvency procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator.<sup>138</sup> These procedures may include the rules designed to limit the enforcement of security interests for the benefit of other creditors or in an attempt to affect a reorganisation of the debtor's business.<sup>139</sup>

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<sup>136</sup> *In re David Larry Davis*, 734 F.2d 604, 10 Collier Bankr. Cas. 2d 1328, 12 Bankr. Ct. Dec. 859, Bankr. L. Rep. P 69, 902; *In re Burton Lewis Arnett*, 732 F. 2d 385, 77 A.L.R. Fed. 1, 10 Collier Bankr. Cas 2d 533, 11 Bankr. Ct. Dec. 1097, Bankr. L. Rep. P 69, 839.

<sup>137</sup> *In the Matter of Oil Fuel Supply*, 827 F.2d 224, 18 Collier Bankr.Cas. 2d 462, 17 Bankr. L. Rep. P 72, 278, 5 UCC Rep. Serv. 2d 1446; *In Re Gem Construction Corp. of Virginia*, 262 B.R. 638.

<sup>138</sup> Art 30(3)(b).

<sup>139</sup> This may include the cases where an automatic stay is imposed to prevent or suspend the enforcement of security interest in a situation where the debtor's business is about to be reorganised. See *Goode* (n 4) 232. But the automatic stay will not be available against the property which does not belong to the debtor. See *In Re North Shore & Central Illinois Freight Co.*, 30 B. R. 377, 10 Bankr.Ct.Dec. 1003; *In re Delaware River Stevedores, Ins.*, 129 B.R. 38, 21 Bankr.Ct.Dec.1596. Note that the automatic stay may not be available if the Contracting State has made a declaration under Art IX of the Luxembourg and Art XI of the Aircraft Protocols which displace Art 30(3)(b).



## Chapter V: Enforcement of Security Interests under the Convention and the Protocols

### 1. General

The strength of security and other international interests held by a creditor in the debtor's asset can really be put to the test in the case of the latter's default or insolvency. Should the debtor default in the agreed payments under a loan secured by an aircraft, the secured creditor may decide to repossess and sell it to obtain repayment of the debt. An attempt at repossession may be hindered by various factors, such as refusal of the state where the aircraft is registered to allow repossession because it forms part of the fleet of the flag carrier of this state.<sup>1</sup> The state of the aircraft registration may also prohibit its de-registration from the national registry system, which will prevent the secured creditor from registering the aircraft in another state.<sup>2</sup> Repossession and sale or lease of the aircraft may also be delayed or prevented if the jurisdiction where the secured creditor seeks to enforce the security interest does not allow such actions without obtaining a court order.<sup>3</sup> In addition, in some jurisdictions the sale may only be allowed by way of a public auction and lease of the repossessed aircraft may be prohibited altogether.<sup>4</sup>

Although a security agreement may provide the secured creditor with a variety of remedies which can be exercised in the case of the debtor's default, the position of such a creditor may change radically if the debtor becomes insolvent.<sup>5</sup> For example, the filing of a petition for reorganisation under Chapter 11 of the US Bankruptcy Code puts an immediate stay on the enforcement of security interests which may lead to further delays and uncertainty in obtaining the repayment of

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<sup>1</sup> For a discussion of 'political' problems and other obstacles which may be encountered by aircraft mortgagee when attempting to repossess and sell the aircraft object see P Thorne, 'Aircraft Mortgages' in N Palmer and E McKendrick (eds), *Interests in Goods*, 2<sup>nd</sup> Ed (LLP, London 1998) 717-725.

<sup>2</sup> Art 18 of the Convention on International Civil Aviation 1944, to which many states are parties, precludes dual registration of aircraft objects.

<sup>3</sup> G Mauri and B Itterbeek, 'The Cape Town Convention on International Interests in Mobile Equipment and its Protocols on Matters Specific to Aircraft Equipment: A Belgian Perspective' (2004) 9 *Unif L Rev* 547, 553.

<sup>4</sup> This is often the case in civil code jurisdiction countries, but there are, of course, exceptions to this. See P Wood, *Comparative Law of Security Interests and Title Finance*, 2<sup>nd</sup> ed (London, Sweet & Maxwell 2007) 376.

<sup>5</sup> Thorne (n 1) 725.

the debt.<sup>6</sup> Similarly, appointment of an administrator under the UK Insolvency Act 1986 automatically stays enforcement of security interests unless leave of the court or the administrator's permission to enforce can be obtained.<sup>7</sup> Often the obstacles in enforcing a security interest may be cumulative – an automatic stay imposed in an attempt to rescue the debtor's business may be coupled with prolonged judicial proceedings which are required in order to obtain a court order for a public sale of the aircraft.<sup>8</sup>

Compulsory freezes and other obstacles to enforcement which may be encountered by the secured creditor in various jurisdictions may take away what was originally granted to it by a security agreement and undermine the strength of the security interest. To this end, Chapter III of the Convention provides a uniform set of rules governing the remedies of the secured creditor and other holders of international interests which can be enforced in the case of the debtor's default and insolvency. The Convention distinguishes between the remedies available to the secured creditor and those exercisable by a conditional seller and lessor.<sup>9</sup> The secured creditor enjoys a greater variety of remedies and, provided that all the necessary prerequisites are met, it may take possession or control, sell or grant a lease of the object, and collect or receive any income or profits arising from the management of such object.<sup>10</sup> In addition, if at any time after default, the debtor and other interested persons agree, the ownership (or any other interest held by the debtor) of the object covered by the security agreement may be transferred to the secured creditor in or towards satisfaction of the debt.<sup>11</sup> In contrast, the remedies available to the conditional seller and lessor are less detailed and consist of power to terminate the agreement and repossess or take control of the object.<sup>12</sup> This reflects the fact that, as the owner of the object, the conditional seller/lessor does not need more extensive remedies and, once the agreement is terminated and the object is repossessed, is free to deal with it as it

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<sup>6</sup> Ibid 725.

<sup>7</sup> Para. 43, Schedule B1, Insolvency Act 1986.

<sup>8</sup> Wood (n 4) 387.

<sup>9</sup> R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment*, Revised edn (Rome, UNIROIT 2008) 40.

<sup>10</sup> Art 8, the Convention.

<sup>11</sup> Art 9, the Convention.

<sup>12</sup> Art 10, the Convention.

wishes.<sup>13</sup> The creditor may also exercise any additional remedies available to it under applicable law provided that they are not inconsistent with the mandatory provisions of the Convention.<sup>14</sup> Such remedies may relate to right to payment of accrued sums<sup>15</sup> and damages for breach of the agreement.<sup>16</sup>

In some cases the debtor may dispute the creditor's right to enforce its international interest. Judicial proceedings aimed at resolving the matter may take considerable time during which the object may deteriorate and income which could have been earned from its exploitation may be lost by the creditor.<sup>17</sup> To address these issues the Convention allows the creditor to obtain speedy judicial relief pending final determination of the dispute.<sup>18</sup> Provided that the creditor adduces evidence of the debtor's default which satisfies the court, it should grant the creditor the speedy relief order. Such orders may take several forms including those allowing the creditor to secure preservation and value of the object, obtain possession, control or immobilisation of the object and, in the case of the aircraft equipment, even the sale of the aircraft object.<sup>19</sup>

The Protocols also provide additional remedies which are specific to the type of mobile equipment in question and can be exercised by all creditors. For example, the Aircraft Protocol stipulates that in the case of the debtor's default, the creditor may procure de-registration of the aircraft from the national registry and export or physically transfer it from the territory in which it is situated to another country.<sup>20</sup> This should allow the creditor to move and re-register the aircraft object in a new jurisdiction where enforcement of remedies may be somewhat easier. Similarly, the Luxembourg Protocol provides that in the case of

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<sup>13</sup> Goode (n 9) 40.

<sup>14</sup> Art 12, the Convention.

<sup>15</sup> For example, in *Brooks v Beirnsstein* [1909] 1 K.B. 98, following the hirer's failure to punctually pay monthly rent for the hired furniture, the owner was able to terminate the agreement and repossess the goods. In addition, it was held that the owner could also sue for monthly rent which had already accrued and have not been paid by the hirer. See also *Financings Ltd v Baldock* [1963] 2 Q.B. 104; *Brady and Another v St Margaret's Trust Ltd* [1963] 2 Q.B. 494; *Yeoman Credit Ltd v Mclean* [1962] 1 W.L.R. 131. Similarly, following termination of an agreement for the lease of an aircraft and repossession of the object, the lessor may be entitled (under applicable domestic law) to claim any sums representing accrued and unpaid installments from the lessee. Art 12 would allow exercise of additional remedies provided that these remedies are not inconsistent with the mandatory provisions of the Convention.

<sup>16</sup> Goode (n 9) 189.

<sup>17</sup> *Ibid* 46.

<sup>18</sup> Art 13, the Convention.

<sup>19</sup> Art X(3), the Aircraft Protocol.

<sup>20</sup> Art IX(1), the Aircraft Protocol.

the debtor's default, the creditor may procure export and physical transfer of railway rolling stock from the territory in which it is situated to another country.<sup>21</sup> Since repossession of the railway rolling stock may cause disruption to the carriage of passengers and freight, this remedy may only be exercised subject to the public service exemption. This means that if the railway object is habitually used for the purpose of providing a service of public importance it may not be repossessed by the creditor.<sup>22</sup> One question which may arise in this respect is whether the interest of the creditor is adequately protected and whether it can still obtain repayment of the debt.<sup>23</sup>

One of the most significant provisions of the Aircraft Protocol relates to the remedies which can be exercised by the creditor in the case of the debtor's insolvency.<sup>24</sup> These remedies may only be exercised if the relevant Contracting State has made a declaration to this effect. The Aircraft Protocol offers two alternative sets of rules governing the creditor's rights in the case of the debtor's insolvency. Once the declaration in favor of either of them is made, the chosen Alternative should be exercised in its entirety. Alternative A requires the person in charge of the insolvency, such as an insolvency administrator or the debtor, either a) to cure all defaults and agree to perform all future obligations within a specified waiting period or b) to give the creditor the opportunity to take possession of the object. Alternative B is the so-called 'soft' option. According to this option the court may permit the creditor to take possession of the object if the insolvency administrator/debtor fails to present the creditor with the opportunity to repossess it. This may only be accomplished if the insolvency administrator/debtor fails to cure all defaults and agree to perform all future obligations in accordance with its notice.<sup>25</sup>

To protect the interests of the debtor against possible abuse by the creditor, the Convention provides that the remedies of the secured creditor must be exercised in a commercially reasonable manner and that a notice should be sent to

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<sup>21</sup> Art VII(1), the Luxembourg Protocol.

<sup>22</sup> Art XXV, the Luxembourg Protocol.

<sup>23</sup> Similar issues arose in the drafting of the Draft Space Protocol as space objects often play a central role in delivering services of public importance in many countries. See J Atwood, 'A New International Regime for Railway Rolling Stock Asset-Based Financing' (2008) 40 UCC L J 3 Art 2.

<sup>24</sup> Art XI, the Aircraft Protocol.

<sup>25</sup> The Luxembourg Protocol adds Alternative C to these options, which is similar to Alternative A.

the debtor as well as to other interested persons before the object can be sold or leased.<sup>26</sup> However, the effectiveness of these requirements may be debatable since there is no intimation as to what consequences may follow if the creditor does not comply with them. This issue and possible solutions will be addressed in the course of the Chapter.

The aim of this Chapter is to assess enforcement of remedies in and out of insolvency as a whole in order to establish whether the Convention provides the creditor with remedies which are effective and readily available. In certain circumstances limitations on creditors' rights may be unavoidable. This may be the case when a balance needs to be struck between the creditor's interest and the interests of general public which are likely to be affected if the object is repossessed. This Chapter will examine whether, when this is the case, the Convention provides the creditor with adequate protection of its interests and affords it an opportunity to obtain repayment of the debt. The area of remedies which may be exercised by the holder of international interest in the case of the debtor's default and/or insolvency is fraught with numerous complicated issues and the scope of this Chapter does not permit their detailed examination. For this reason, this Chapter aims at providing a roadmap to the remedies which can mainly be exercised by the secured creditor and the remedies of conditional seller and lessor are not addressed.

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<sup>26</sup> Art 8(3), (4), the Convention.

## 2. Default remedies of the secured creditor

### 2.1 *Defining 'default'*

Default of the debtor allows the creditor to exercise its remedies under the Convention. In most cases, events constituting default will be exhaustively defined in the agreement creating the international interest.<sup>27</sup> For example, non-payment of rentals due under an agreement for the lease of an aircraft or filing of a petition for the winding up of the debtor will usually amount to default. But a carefully drafted agreement will include other obligations of the debtor as well as events which are not typically treated as default at all. In many cases, failure to maintain and repair an aircraft to keep it in an airworthy condition,<sup>28</sup> failure to procure insurance naming the secured creditor as a loss payee<sup>29</sup> or non-payment of taxes and charges associated with the use of the object will constitute default.<sup>30</sup>

If the parties do not define it, the Convention states that 'default' amounts to such a default which substantially deprives the creditor of what it is entitled to expect under the agreement.<sup>31</sup> This means that not every breach of a term of the agreement will constitute a default. So if the breach of the term is a minor one, such as when the debtor fails to pay one out of twenty installments due under the lease, this is not likely to constitute a default under the Convention at all.<sup>32</sup> It is important to define default accurately because if the breach of the term is not the one which substantially deprives the creditor of its contractual expectation, it will not be able to enforce the remedies under the Convention.<sup>33</sup>

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<sup>27</sup> Art 11(1), the Convention.

<sup>28</sup> *Burton Davis III v American Jet Leasing*, 864 F. 2d 612, 27 Fed. R. Evid. Serv. 26.

<sup>29</sup> Such an insurance policy will entitle the creditor to claim the amount of covered loss from the insurer which may include cost of repair and diminution of value of an aircraft following an accident and damage to its constituent parts. See *Center Capital Corporation v National Union Fire Insurance Company of Pittsburgh*, 2010 WL 3941933 (D. Idaho).

<sup>30</sup> H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (Oxford, OUP 2007) 573.

<sup>31</sup> Art 11(2), the Convention.

<sup>32</sup> At the same time, if punctual payment is said to be of the essence of the lease, it may amount to default under the agreement allowing the creditor to terminate it and repossess the object. This was the position in *Lombard North Central Plc v Butterworth* [1987] Q.B. 527. In such a case the creditor would have to proceed under Art 11(1) of the Convention.

<sup>33</sup> The creditor may exercise any additional remedies (such as damages suffered as a result of delay in payment) available to it under the applicable law as long as they are not inconsistent with the Convention. See Art 14 of the Convention.

The definition of default provided by the Convention may give rise to several questions. First, it is not entirely clear what constitutes the creditor's expectation under the agreement. Secondly, it may be difficult to ascertain the breach of which terms may lead to substantial deprivation of such contractual expectation. With regard to the first issue, it may be argued that contractual expectation should be defined with reference to the obligations stated in the agreement in the sense that the debtor's performance of its obligations can be said to be what the creditor expects under the contract. In accordance with this approach, if the agreement states that the insurance covering certain political risks should be provided by the debtor and this has not been accomplished, the creditor should be entitled to consider such breach as default depriving it of its contractual expectation. The difficulty with this approach is that it may not provide a clear answer as to when the secured creditor will be substantially deprived of its contractual expectations.

Alternatively, it may be argued that contractual expectation of the creditor should be defined with reference to the purpose of its entering into the agreement in the first place. Once this purpose is established, it may be easier to ascertain whether the breach of a term is likely to substantially deprive the creditor of its contractual expectation. The main reason why the secured creditor enters into a security agreement is to protect itself against default of the debtor. The secured creditor expects that the secured loan will be repaid with interest or, if the repayment is no longer possible, that it will have access to the asset of the debtor which serves as a security for the performance of its obligation. The conditional seller intends to sell the object to the buyer and expects that all installments constituting the purchase price will be paid. If the purchase price cannot be obtained, the conditional seller expects that, as the owner of the object, it will be able to take it back. Similarly, when the lessor delivers possession of the equipment to the lessee it expects to receive rental payments for its use or to be able to repossess it. Once the expectations of the creditor under the agreement are ascertained it becomes clearer that breach of some terms may interfere with them more than breach of the other terms. For example, failure to pay several installments may result in a loss to the creditor, but it is unlikely to substantially deprive it of its contractual expectation, namely that the debt will eventually be

repaid.<sup>34</sup> But if the debtor indicates that it can no longer pay the installments even if the creditor agrees to reschedule the debt or if it files a petition for reorganisation, the debt may never be fully repaid and the creditor may be substantially deprived of its contractual expectation. When the majority of the installments are not paid or where the debtor indicates that it is no longer in the position to perform its obligations, the creditor may decide to repossess and sell the aircraft. The creditor may find that the proceeds of sale cannot be transferred to the state where it is based or cannot be converted into the currency of its choice. This may mean that the debt cannot be repaid out of such proceeds and the creditor will be substantially deprived of its expectation to obtain repayment. For this reason, failure to provide insurance covering such loss is likely to amount to default under the Convention.

Whether the test of substantial deprivation of contractual expectations will be satisfied will probably depend on the circumstances of each case and future cases decided under the Convention will be vital in drawing its contours. One factor which may help to decide whether the breach of a term substantially deprives the creditor of its expectation is to consider the nature and seriousness of the negative consequences flowing from it: if the breach of the term goes to the very core of the essence of the agreement, such as when it will lead to serious risk of non-repayment of the debt, diminution of the value of the security interest or destruction or loss of the object, it is likely to amount to default under the Convention. In such cases it may be argued that the term of the agreement is so important to the protection of the creditor's interest and to the essence of the agreement that it may be presumed that any breach of such a term will lead to substantial deprivation of its contractual expectation. For this reason, the breach of such a term should automatically be treated as default allowing the creditor to enforce the relevant remedies. For example, if the debtor fails to arrange insurance covering the costs associated with damage, maintenance and repair of the aircraft, the breach of this term is likely to lead to substantial deprivation of the creditor's contractual expectation. Should the aircraft be involved in an accident resulting in damage to its parts, the costs of repairing it are likely to be significant which may

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<sup>34</sup> The situation may be different if the agreement indicates that failure to pay even a single installment punctually amounts to default. See Goode (n 9) 188.



affect the debtor's financial standing and increase the risk of non-repayment of the debt. This may also diminish the value of the security interest. Instead of having a security in an airworthy aircraft which could be repossessed and sold or leased with relative ease, it now has to deal with an object which is in need of costly repairs, failing which it may only be sold in a disassembled condition and not as a whole. Similarly, if the agreement requires the debtor to obtain a written assurance from the government of the state where the aircraft is registered confirming that the aircraft may be de-registered and repossessed without its consent, failure to procure such an assurance may meet the substantial deprivation requirement. The secured creditor may have agreed to provide a loan secured by the aircraft on the understanding that in the case of the debtor's default, it will be able to de-register the object and export it to another jurisdiction where the rules governing enforcement of security interests are more creditor-oriented. In contrast, the state of the aircraft's current registration may not allow private sale and the secured creditor may consider that a public auction is unlikely to generate proceeds sufficient to cover the repayment of the debt.

In many cases the position may not be as clear cut as in the above examples. Consider a secured creditor who learns that the insurance covering maintenance and repair of the aircraft has lapsed and the debtor failed to renew it. This may lead to substantial deprivation of contractual expectation and the creditor may argue that this breach constitutes the default. But what if the debtor assures the creditor that it will procure a new insurance policy within the next three days? Can the creditor still treat the breach as the default and proceed with repossession and sale of the aircraft or should it refrain from enforcing its remedies and wait until the default is cured? On the one hand, it may be suggested that since the secured creditor's remedies of repossession and sale are extremely powerful in that they lead to dispossession of the debtor of its most valuable object, the breach which may be cured should not be treated as a default. On the other hand, if the debtor continues to operate the aircraft (in defiance of the secured creditor's instructions) at the time when it is not insured and the object is damaged during this time, the security interest of the creditor is likely to be impaired. For this reason, the creditor may be entitled to insist on continuous insurance cover and to treat the breach of the term relating to it as the default. Once the insurance policy

is obtained, the secured creditor may learn that while it covers the costs associated with maintenance and repair of the object, it does not cover the political risks or not all of the political risks which were expected to be addressed by the creditor. For example, while the policy may cover the risk of the state's refusal to de-register the aircraft, it may not stipulate for any loss which the creditor is likely to suffer if, under the applicable currency law, the proceeds of sale cannot be remitted outside or converted into an acceptable currency. This too may substantially deprive the creditor of its contractual expectation to obtain repayment of the debt and is likely to be treated as the default.

While the factor of seriousness of negative consequences may serve as a starting point in ascertaining the breach of which terms will substantially deprive the creditor of its contractual expectations, it may be argued that it raises the bar too high. It means that only an exceptionally serious breach of a term will entitle the creditor to exercise its remedies and this could not have been implied by the text of the Convention. In other words, the breach need only satisfy the requirement of substantial and not necessarily total deprivation of contractual expectation. While the breach of the term which goes to the very core of the agreement should undoubtedly amount to the default, the category of the default cannot be restricted to only such breaches.

Another factor which may help to decide whether the breach of a term substantially deprives the creditor of its expectation is to consider whether, despite of the breach, a reasonable person in the position of the creditor can still obtain what it is entitled to expect under the agreement. Consider a security agreement containing a restriction on the debtor's leasing or otherwise parting with possession of the aircraft. The reasons why the secured creditor may require such a restriction may include the following.<sup>35</sup> Leasing of the aircraft may lead to a change in the aircraft's registration with adverse consequences for the secured creditor whose priority position may be changed or lost. If the lessee intends to operate the aircraft in a different country, this may increase 'political risks' for the secured creditor. The secured creditor may also be concerned whether the interest of the lessee will be subordinate to that of the secured creditor. If, in defiance of

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<sup>35</sup> See Thorne (n 1) 704.

the restriction, the debtor leases the aircraft, the reasonable person in the position of the creditor may have to consider the circumstances before deciding whether it can still obtain the repayment of the debt. If the lessee agrees that its interest will be subject to the secured creditor's interest (so that the creditor can still repossess the object) and rental payments under the lease will be remitted to the secured creditor in satisfaction of the secured debt, the reasonable person in the position of the creditor may consider that it can still obtain the repayment of the debt. This means that such a breach should not substantially deprive the creditor of its contractual expectation. On the other hand, if the secured creditor learns that the debtor entered into a long-term lease involving the change of the aircraft's registration and the nameplates stating that the aircraft is charged or mortgaged to the secured creditor have been removed from the airframe and the engines of the aircraft, the position may be different. In this case, the reasonable person in the position of the creditor is likely to be substantially deprived of its contractual expectation because the change in registration may cause the loss of the priority position among other creditors and removal of the nameplates may mean that its security interest may no longer be visible to other interested persons.

Finally, whether the breach of the term may be cured by the debtor may also serve as a relevant consideration in deciding whether it should amount to a default. For example, where the breach of the debtor consists in the failure to place nameplates on aircraft engines indicating that the creditor has security interest in them, this breach can be cured at no inconvenience to the creditor. The purpose of placing the nameplate is to provide an additional safeguard that the security interest in the engines will be visible to other persons, but it does not help the secured creditor to secure a priority position, nor does it serve as a notice to other creditors.<sup>36</sup> To achieve the latter objectives, the secured creditor will have to register its interest in the International Registry.

## 2.2 Default remedies of the secured creditor: an overview

In the event of the debtor's default the secured creditor may exercise the following remedies. It may a) take possession or control of any object charged to it; b) sell or grant a lease of any such object; c) collect or receive any income or

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<sup>36</sup> Ibid 705.

profits arising from the management or use of any such object.<sup>37</sup> Alternatively, the secured creditor and all the interested persons, including the debtor, may agree that ownership of (or any other interest of the debtor in) any object covered by the security interest shall vest in the secured creditor in or towards satisfaction of the debt.<sup>38</sup> The remedies available to the secured creditor are not automatic and may only be exercised to the extent that the debtor has at any time so agreed.<sup>39</sup> Although the Convention does not prescribe any remedies which may be exercised by the debtor in the case of the creditor's abuse of its powers, it provides several safeguards which are aimed at ensuring that its interest is also protected. One example of such safeguards is the requirement that the remedies of the creditor can only be exercised with the debtor's consent, which may be given when the security agreement is concluded or at any other time.<sup>40</sup> The extent of the debtor's consent may also be stipulated in the security agreement. For example, the parties may agree that the secured creditor may only take possession or control of the object if this can be accomplished without breaching the peace<sup>41</sup> or causing interruption to its immediate operation. The security agreement may specify that the secured creditor may only repossess the aircraft if it is not operated at the moment of intended repossession: if the passengers and their luggage are already on board and the aircraft is getting ready to take off, it should not be prevented from embarking on its flight.<sup>42</sup> In some instances it may be difficult to obtain the requisite consent of the debtor. When this happens, the secured creditor may apply for a court order authorising or directing any of the remedies available to the secured creditor.<sup>43</sup>

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<sup>37</sup> Art 8, the Convention.

<sup>38</sup> Art 9, the Convention.

<sup>39</sup> Art 8(1), the Convention.

<sup>40</sup> Goode (n 9) 181.

<sup>41</sup> In some jurisdictions this is one of the preconditions of repossession. For example, s. 9-609(b)(2) Article 9 UCC allows repossession without judicial process only if it can be accomplished without breach of the peace. There is extensive case law on this matter. See *General Finance Corporation v Smith*, (1987) 505 So.2d 1045, 3 UCC Rep.Serv.2d 1278; *Sanchez v Mbank of El Paso*, (1990) 792 S.W.2d 530, 12 UCC Rep.Serv.2d 1169; *King v Citizens Bank of Warrensburg*, (1990) WL 154210 (D.Kan.); *Saice v MidAmerica Bank*, (1999) WL 33911356 (D.Minn.); *Yakity Yaks v Thielen*, (2002) WL 31496416 (D.Or.).

<sup>42</sup> This may mean that the secured creditor or its representative may have to wait until the aircraft comes back to the airport before repossessing it or to prevent it from taking off. See A Muriel, 'Inside Story on a Very Exclusive Club for Lawyers' (2002) 1 *European Lawyer* 23, 24. In this note the author recollects a case where a snow plough had to be parked behind an aircraft to prevent it from flying and to enable repossession.

<sup>43</sup> Art 8(2), the Convention.

The remedies of the secured creditor must be exercised in a commercially reasonable manner which means that they should be exercised in conformity with the provision of the security agreement unless such provision is manifestly unreasonable.<sup>44</sup> The requirement of commercially reasonable exercise of remedies is another example of a safeguard provided by the Convention which is aimed at protecting the debtor's interest.

The remedies may be exercised either extra-judicially or on application to the court. This may depend on the declaration which should be made by a Contracting State at the time of ratification, acceptance, approval of, or accession to the Protocol.<sup>45</sup> This declaration is mandatory<sup>46</sup> and it should indicate whether remedies which under the Convention would be available without intervention of the court are to be exercisable only on application to the court or whether they can be exercised extra-judicially. The provision of the Convention requiring this declaration reflects the fact that while some jurisdictions allow self-help remedies, other jurisdictions may oppose to such an approach.<sup>47</sup> It is up to the Contracting State to choose which of the two approaches it prefers. The declaration indicating its position will clarify the matters for the secured creditor who otherwise may not be certain how to proceed with the enforcement of the remedies. The availability of self-help remedies may mean that the time and cost of enforcement may be considerably reduced. But, even if the declaration allows the secured creditor to repossess, sell or grant a lease without leave of the court, it may still choose to apply for the court order before enforcing its remedies. The secured creditor may prefer the judicial route in order to avoid being sued for trespass (if it enters the debtor's property when repossessing the aircraft) or damages for wrongful repossession.<sup>48</sup> If the aircraft is sold privately, the sale may be challenged by the debtor if it can be demonstrated that the secured creditor failed to obtain a proper price reflecting the true market value of the object<sup>49</sup> or that the sale was not

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<sup>44</sup> Art 8(3), the Convention.

<sup>45</sup> Art 8(1), 54(2), the Convention.

<sup>46</sup> This is clear from the language of Art 54(2) stating that a Contracting State shall declare whether or not any remedy available to the creditor under the Convention which is not there expressed to require application to the court may be exercised only with leave of the court. In contrast, the declaration under Art 54(1) in relation to the lease of the charged object is optional.

<sup>47</sup> Goode (n 9) 281.

<sup>48</sup> Thorne (n 1) 719.

<sup>49</sup> *Cuckmere Brick Co v Mutual Finance Ltd* [1971] Ch. 949. In this case the duty to take reasonable care to obtain the true market value of the mortgaged property was breached because

conducted in a commercially reasonable manner.<sup>50</sup> In addition, the aircraft authorities may refuse to grant the secured creditor an operating licence or airworthiness certificate which is necessary for the operation of the aircraft. A court order may help the secured creditor in persuading the relevant authorities to issue it with these documents.

Finally, the secured creditor does not have to choose which remedy to exercise and can enforce any one or more of such remedies.<sup>51</sup> In many cases the secured creditor will need to take possession or control of the object before selling or leasing it to another party. If sale of the aircraft in another jurisdiction is likely to increase sale proceeds, the secured creditor may need to de-register and export it to such jurisdiction before the sale can be arranged. In certain circumstances it may be better not to sell the object immediately. On a falling market, the secured creditor may decide to obtain a vesting order transferring the debtor's title in the object to it in or towards satisfaction of the debt. Once the market is improved, the creditor may be able to sell the object at a profit.

#### 2.2.1 Taking possession or control of the object

Taking possession or control of such high value and unique objects as aircraft, railway and space objects may prove to be expensive and burdensome. The secured creditor in possession of an aircraft or a railway object may need to obtain

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the mortgagee failed to advertise planning permission for flats which had already been obtained and which affected the price of the mortgaged land.

<sup>50</sup> Similar to the Convention, s. 9-610 of Article 9 UCC requires that every aspect of sale, lease or other disposition should be conducted in a commercially reasonable manner. There is extensive case law on this matter and in some cases there are many factors which may be relevant in considering whether the sale was conducted in a commercially reasonable manner. For the discussion of this issue and the relevant factors see W Rudow, 'Determining the Commercial Reasonableness of the Sale of Repossessed Collateral' (1986) 19 UCC LJ 139, 140-158. For the criticism of the concept of commercial reasonableness see D Rapson, 'Who is Looking Out for the Public Interest? Thoughts about the UCC Revision Process in the Light (and Shadow) of Professor Rubin's Observations' (1994) 28 Loy LA L Rev 249, 158-159.

<sup>51</sup> Art 8(1), the Convention. The position is, generally, similar in some other jurisdictions. For the position under US law see *Glamorgan Coal Corporation v Bowen*, (1990) 742 F.Supp. 308, 13 UCC Rep.Serv.2d 596 in which the secured creditor, after obtaining monetary judgment for debt owed to it by the debtor, was able to take possession of collateral and sell it to recover the remainder of the debt; *Ingersoll-Rand Financial Corporation v Atlantic Management and Consulting Corp.*, (1989) 717 F.Supp. 1067, 10 UCC Rep.Serv.2d 256; *Midlantic Commercial Leasing v Tender Loving Care*, (1990) WL 72861(E.D.Pa.), 12 UCC Rep.Serv.2d 293; *Vital Basics v Vertrue Incorporated*, (2007) 515 F.Supp.2d 170; *AVCO Financial Services of Billings One v Christiaens*, (1982) 201 Mont. 117, 652 P.2d 220, 34 UCC Rep.Serv. 1445; *In re Adrian Research & Chem. Co.*, (1959) 269 F.2d 734; *Bank One Akron v Nobil*, (1992) 80 Ohio App.3d 638, 610 N.E. 2d 538. English law also permits the secured creditor to exercise any available remedies either singly or concurrently. See Beale, Bridge, Gullifer, Lomnicka (n 30) 610.

a licence or other necessary certificates enabling it to operate the object or to employ a person who specialises in operating these objects.<sup>52</sup> The costs of storing, preserving, transporting, maintaining and repairing an aircraft or a railway object are likely to be substantial. In the case of the aircraft objects, the secured creditor will also have to pay landing fees as well as navigation, visual and radio charges. When taking possession of the aircraft is followed by de-registration and transportation to another jurisdiction, the secured creditor will have to obtain approval from the relevant authority in the state where the aircraft is located.<sup>53</sup> If repossession is challenged as wrongful or premature or where operation of the object causes environmental pollution or other damage, the secured creditor may also have to pay for the resulting damage.<sup>54</sup>

The disadvantages associated with repossession may mean that the secured creditor will not always be ready and willing to take possession of the aircraft or the railway object. But if moving the object to a different jurisdiction may help the secured creditor to avoid lengthy insolvency stays, delayed court proceedings and increase the likelihood of better sale proceeds, the secured creditor may decide to repossess. Another reason why the secured creditor may take possession of the aircraft or the railway object is to manage the object where the debtor has ceased trading or to keep it in operation so that the profit may still be earned.<sup>55</sup> By taking possession, the secured creditor may also intercept any rental payments which may be due under the leases provided that they do not terminate once the security interest is enforced. Most importantly, the secured creditor may need to take possession of the aircraft or the railway object in order to sell it.<sup>56</sup> Taking possession is a powerful remedy because it divests the debtor of its most valuable asset and in some cases a mere threat of repossession may induce the debtor to cure the default.<sup>57</sup> Once the secured creditor gains physical control over the aircraft object, it may find it easier to negotiate with the debtor because the loss or unavailability of even one aircraft may cause serious disruption to the latter's

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<sup>52</sup> Wood (n 8) 370.

<sup>53</sup> See *C.I.T. Leasing Corp. v Brasmex-Brasil Minas Express LTDA*, No 03 Civ. 5077(DAB) (FM), 2007 where costs associated with repossession and de-registration of an aircraft (excluding attorney's fees) run in excess of \$680,000.

<sup>54</sup> Wood (n 8) 369.

<sup>55</sup> *Ibid* 369.

<sup>56</sup> F Adeoye, 'The Anglo-American Law of Mortgagees: A Quagmire for Creditors' [1993] JBL 544, 547.

<sup>57</sup> J White and R Summers, *Uniform Commercial Code*, 5<sup>th</sup> Ed (West Group 2000) 890.

flight schedule. Since the Convention permits self-help repossession,<sup>58</sup> the secured creditor may be able to seize the object without applying for a court order which may help it save both time and cost. The availability of the remedy of repossession may also mean that the secured creditor may be more certain that if the debtor defaults, it can take the object and realise it to obtain repayment of the debt. This may reduce the risk of non-repayment and give the debtor access to credit at lower cost.<sup>59</sup>

When exercising the remedy of repossession arising under the Convention the secured creditor may be faced with several issues. First, should the secured creditor send a notice of the intention to repossess to the debtor before taking the object or can it simply turn up at the airport or the railway junction and take the object away? Once the object is repossessed, does the secured creditor owe any duties in relation to its preservation, maintenance and insurance? The secured creditor may also need to know whether it has any obligations in relation to operation of the object in a way that would prevent it from deterioration and loss of profit which could have been earned but for repossession or whether it could simply store it in a hangar pending repayment of the debt.<sup>60</sup> These issues will be considered in turn.

To take possession of the aircraft or railway object, the secured creditor may need to examine its flight or train schedule, obtain permissions from the relevant authorities and use specific equipment, but once the aircraft or train arrives, the secured creditor should be able to seize it. Where the secured creditor needs to exercise repossession in a different jurisdiction, it may need to send a team of its representatives to a different country and that team will have to wait until the aircraft or train arrives there. But in some cases the charged object may not be located on Earth at all, in which case taking possession of it may be impossible or very difficult to achieve. This is particularly relevant in the case of space objects,

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<sup>58</sup> Although the Convention allows extra-judicial repossession, this right may be varied by a declaration of the Contracting State. See Art 54(2) of the Convention.

<sup>59</sup> T Zinnecker, 'The Default Provisions of Revised Article 9 of the Uniform Commercial Code: Part I' (1998-99) 54 *Bus Law* 1113, 1140.

<sup>60</sup> If the repossessed object was leased by the debtor to a lessee, the secured creditor may also need to know whether the lessee's interest is subjected to that of its own so that the rental payments could be remitted to the secured creditor instead of the debtor/lessor. For a detailed treatment of the issues which may arise in this context see R Kratovil, 'Mortgages – Problems in Possession, Rents, and Mortgage Liability' (1961-1962) 11 *DePaul L Rev* 1.



such as satellites and its component parts. When taking actual possession is not possible, the secured creditor's next best option is to take control over the object. To take control over the orbiting satellite the secured creditor may need to obtain access to telemetry, tracking and command (TT&C) facility.<sup>61</sup> The code to the TT&C may be changed or caused to be changed at the request of the secured creditor which should enable it to take control over the space object.<sup>62</sup> The draft Space Protocol provides that parties to the security agreement can agree to place codes giving access to the space object with a third party in order to give the secured creditor the opportunity to establish control over the object in the case of the debtor's default.<sup>63</sup>

a) Notice of the intention to take possession

Once the debtor is in default, the secured creditor may take possession of the object. The Convention does not state whether the secured creditor has to notify the debtor of the default and to inform it of its intention to take possession of the object. In contrast, the secured creditor proposing to sell or lease the object has to give reasonable prior notice in writing to all interested persons including the debtor informing them of the proposed disposition.<sup>64</sup> The reason why the secured creditor is required to inform interested persons of the proposed disposition is that the sale or lease of the object may affect the interests of other persons as well as those of the debtor.<sup>65</sup> The sale of the object may also prevent the debtor from discharging the secured obligation and recovering the object from the creditor. The purpose of the reasonable notice served prior to the proposed disposition is to warn interested persons that their position may be changed and to give them an opportunity to cure the default in order to prevent the loss of the object. But when the secured creditor is merely proposing to take possession of the object, repercussions may be less serious and the position may still be reversed even after

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<sup>61</sup> D Panahy and R Mittal, 'The Prospective UNIDROIT Convention on International Interests in Mobile Equipment as applied to Space Property' (1999) 4 Unif L Rev 303, 309.

<sup>62</sup> Ibid 309.

<sup>63</sup> Art XX of the draft Space Protocol. See M Stanford, 'The Preliminary Draft Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets' (2010) UN/Thailand Workshop on Space Law, 'Activities of States in Outer Space in Lights of New Developments: Meeting International Responsibilities and Establishing National Legal and Policy Frameworks' 1, 15.

<sup>64</sup> Art 8(4), the Convention.

<sup>65</sup> Goode (n 9) 182.

repossession takes place. So if the debtor tenders unpaid interest and agrees to pay all further installments in due course, the aircraft may be returned to it. Another reason why the Convention does not require the secured creditor to send notice of intention to repossess may be that in most cases the debtor will be aware of the default and can expect that the object will be repossessed. If this is the case, the requirement of notice informing the debtor of intended repossession may be superfluous.

The position may be less clear if the secured creditor initially refrains from taking possession of the object despite defaults of the debtor, but later decides to repossess. This may happen if the debtor fails to pay several installments due under the security agreement or if the debtor is consistently late in making the payments. Because of the disadvantages associated with repossession, the secured creditor may agree to reschedule the debt in order to make repayment easier for the debtor. Alternatively, the secured creditor may simply accept late payments instead of repossessing the object. But if the situation does not improve and the defaults continue to occur, the secured creditor may be forced to repossess. The question which may arise at this point is whether the secured creditor should be required to inform the debtor of intended repossession or whether it can take the object away without any prior notice. The answer to this question may turn on the interpretation of the security agreement and, for this reason, may not be governed by the Convention at all. For example, a security agreement may contain a 'no-waiver clause' indicating that acceptance of late payments should not amount to the waiver of the secured creditor's remedies. If the debtor fails to pay installments on time and the secured creditor accepts belated payments, but later (following another default) decides to take possession of the object, the debtor may attempt to challenge repossession. It may be argued that earlier acceptances of late payments by the secured creditor established a course of conduct between the parties whereby the debtor could trust that belated payments would be accepted. Accordingly, it may be suggested that if the secured creditor decides to break the pattern of accepting the defaults and to repossess the object, it should be required to send the debtor a prior notice of its intention failing which repossession may be held to be wrongful. This view found some support in cases decided under US law. For example, in one case the agreement for the lease of a

pick-up truck provided that the bank could terminate the lease and repossess the object in case of the debtor's failure to pay rental payments or to procure insurance.<sup>66</sup> The bank did not repossess the truck even though the insurance cover was interrupted for ten months and the debtor was consistently late in paying the rentals. Instead, the bank 'nursed the transaction along' by reminding the debtor about payments and accepting late tenders. Then, without any prior notice, a collecting agent of the bank who learned about the defaults repossessed the truck. It was held that the course of dealing established between the parties whereby the bank accepted late payments did not result in the waiver of its right to repossess the object following the debtor's default. But a secured creditor who did not insist on strict compliance in the past must, before it can rely on the 'no waiver' clause and repossess the object, notify the debtor that strict compliance with the contract would be required in order to avoid repossession.<sup>67</sup> Since the bank did not notify the debtor of its intention to terminate or take possession of the truck, repossession was held to be wrongful.

On the other hand it may be suggested that the 'no waiver' clause should be enforceable and that the secured creditor should not be punished for helping the debtor in financial difficulties. On this view, the secured creditor should be permitted to effect repossession without any prior notice even if it accepted previous defaults of the debtor. This may also benefit the debtor, because if the secured creditor can be certain that it will not be penalised for its forbearance, it may be more willing to accept late payments rather than to declare the default.<sup>68</sup> In addition, requiring the secured creditor to send prior notice of intended repossession where late payments were previously accepted, but not in other cases may cause confusion and encourage the secured creditor to take possession of the

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<sup>66</sup> Nevada National Bank v Huff, 94 Nev. 506, 582 P.2d 364, 24 UCC Rep.Serv.1044, 1978.

<sup>67</sup> Similarly, in Cobb v Midwest Recovery Bureau Company, 295 N.W. 2d 232, 28 UCC Rep Serv. 941, 1980, the repossession of the truck was held wrongful where the financing company accepted late payments, but gave no notice of intention to repossess before demanding the payment in full. See also in Steichen v First Bank Grand, 372 N.W. 2d 768, 41 UCC Rev. Serv. 1866, 1985 and Slusser v Wyrick, 28 Ohio App.3d 96, 502 N.E. 2d 259, 1986 where it was held that repossession of the object was wrongful because the secured creditor did not notify the defaulting debtor of its intention to repossess or terminate the agreement.

<sup>68</sup> Monarch Coaches v ITT Industrial Credit, 818 F.2d 11, 3 UCC Rep. Serv.2d 1274, 1987. See also K.B. Oil Company v Ford Motor Credit Company, 811 F.2d 310, 3 UCC Rev. Serv. 2d 417; Lewis v National City Bank, 814 F. Supp. 696, 21 UCC Rep. Serv. 2d 380, 1993.

object even in those cases where the default of the debtor would have been condoned if duly cured by the debtor.

With regard to the Convention it is suggested that the fact that prior notice is expressly required in the cases of proposed sale and lease, but is not mentioned in the case of the repossession means that the secured creditor is not required to send a notice to the debtor before taking possession of the object. This does not necessarily mean that the secured creditor will simply send a team of its representatives to the airport airfield and tow the aircraft away. If repossession is not handled correctly, the secured creditor may face liability for wrongful repossession or trespass under the applicable law.<sup>69</sup> To avoid litigation and possible liability it may be prudent to serve notice of default and intended repossession even if this may not be required under the agreement or the Convention.

b) Duties in relation to the repossessed object and the standard of commercial reasonableness

Once the aircraft (or railway) object is repossessed it will need to be stored in a suitable place where it can be protected from various weather conditions and elements which can cause its deterioration. It will also need to be maintained, repaired and insured in order to preserve its value. In this regard, the secured creditor may need to establish whether it owes any duties to the debtor in relation to preservation of the object or whether it can simply tow the aircraft away from the debtor's parking space to a different place at the airfield and leave it there until the debt is repaid. The Convention does not impose on the secured creditor any duties in relation to the repossessed object. But repossession of the aircraft or railway object does not render the secured creditor the owner of these objects. If the secured creditor collects or receives any sum as a result of repossession, it cannot appropriate it to its own needs and will have to apply this sum towards discharge of the secured obligation.<sup>70</sup> Should the debtor cure the default (by paying any unpaid interest and installments) before the aircraft or railway object is

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<sup>69</sup> In contrast to the Convention, some legal systems require the secured creditor/lessor to send notice of default and intended repossession to the debtor/lessee before the object can be taken away. See T Rodrigues, 'International Regulation of Interests in Aircraft: the Brazilian Reality and the UNIDROIT Proposal' (2000) 65 J Air L Com 279, 298-299.

<sup>70</sup> Art 8(5), the Convention.

sold or leased, the secured creditor may have to return the object to it. If the debtor learns that the condition of the aircraft has deteriorated while in possession of the secured creditor because it was not kept in a suitable hangar and properly maintained or that its value diminished because it was involved in an accident and not properly insured, the secured creditor may be held liable for any resulting loss suffered by the debtor. Since repossessed object does not belong to the secured creditor, it should exercise care in relation to this object while it is in its custody.

In addition, although the Convention does not expressly impose on the secured creditor a duty of care in relation to the repossessed object, it states that any remedy available to it should be exercised in a commercially reasonable manner.<sup>71</sup> The duty of care in relation to the repossessed object may arise out of this requirement: it is unlikely to be commercially reasonable to leave the aircraft in the airfield where it can rapidly deteriorate. Instead, the secured creditor should arrange for a proper storage facility. Similarly, it may not be commercially reasonable to keep the aircraft uninsured and not to perform necessary maintenance and repair works. Failure to exercise reasonable care in preservation of the object while it is in possession of the secured creditor may result in diminution of value, deterioration of condition and loss of the object. It may make the possibility of repayment of the secured debt even fainter and result in unnecessary waste of a valuable asset belonging to the debtor.<sup>72</sup>

This view may be supported by the judgment of Sir R. Scott V.-C. in *Medforth v Blake and Others*.<sup>73</sup> In that case the receivers took possession and managed the pig-farming business of the mortgagor. Despite several reminders from the mortgagor that it only bought pig-feed from a particular supplier at a substantial discount, the receiver did not request or obtain the discount and purchased the pig-feed at full price causing the mortgagor considerable loss. In

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<sup>71</sup> Art 8(3), the Convention.

<sup>72</sup> Similarly, under English law, the mortgagee in possession is under a duty to preserve and take reasonable care in relation to the physical state of the object. See *Palk and Another v Mortgage Services Funding Plc* [1993] Ch. 330, 338. Cases where the object is repossessed but not exploited are rather more complicated: the question here is the extent of the mortgagee's duty to make whatever profit could have been made from the collateral. See *White v City of London Brewery* (1889) 42 Ch. D. 237.

<sup>73</sup> [2000] Ch. 86. For a detailed discussion of this case and the duties of the mortgagee/receiver owed to the mortgagor see S Frisby, 'Making a Silk Purse out of Pig's Ear-Medforth v Blake & Ors' (2000) 63 MLR 413.

considering whether once the receiver took possession and decided to carry on the business of the mortgagor it owed the former a duty of care, *Sir R. Scott V.-C.* stated the following:

The proposition that, in managing and carrying on the mortgaged business, the receiver owes the mortgagor no duty other than that of good faith offends, in my opinion, commercial sense. The receiver is not obliged to carry on the business... But if he does decide to carry on the business why should he not be expected to do so with reasonable competence? The present case... involves the failure of the receivers to obtain discounts that were freely available. Other glaring examples of managerial incompetence can be imagined. Suppose, the receivers had decided to carry on the business but had decided...that the pigs need not be fed or watered more than once a week, and as a result a number of pigs had died...It is accepted that, if the mortgagee had gone into possession and carried on the business similarly incompetently, the mortgagee would have been accountable to the mortgagor for the loss caused to the mortgagor by the incompetence.<sup>74</sup>

Similarly, in *McHugh v Union Bank of Canada*,<sup>75</sup> the case involving a mortgage of a herd of horses, the mortgagee bank took possession of the horses and drove them to a different location for sale. The horses were driven too hurriedly without sufficient time to feed and, as a result, some of them were put out of condition and some died causing loss to the mortgagor. The mortgagor was awarded damages for the mortgagee's negligent breach of its duty of care. In both cases, the secured creditor took possession of the charged objects, but failed to take steps to preserve their value. By analogy with these cases it may also be argued that when the secured creditor takes possession of the aircraft or railway object of the debtor it should take reasonable care in order to preserve, maintain, insure and prevent their deterioration or loss. The exercise of these measures should be accomplished in a commercially reasonable manner, which may mean that the secured creditor should behave responsibly, attempt to minimise waste and take account of the debtor's interests.

The difficulty with the standard of commercial reasonableness is that it is not defined by the Convention. For this reason it may be difficult to ascertain exactly how repossession should be exercised in order to comply with the test. The only explanation of the meaning of the requirement of commercial reasonableness given in the Convention is that a remedy shall be deemed to be exercised in a commercially reasonable manner where it is exercised in

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<sup>74</sup> [2000] Ch. 86, 93.

<sup>75</sup> [1913] A.C. 299.

conformity with a provision of the security agreement unless such a provision is manifestly unreasonable.<sup>76</sup> This explanation may provide some guidance in ascertaining what amounts to the commercially reasonable repossession. For example, the security agreement may state that if the object is repossessed, the secured creditor should not be permitted to simply store the aircraft in the hangar. Instead, it should continue to operate it and apply all sums received from the flights performed by the aircraft towards satisfaction of the secured obligation. If this provision is not manifestly unreasonable, i.e. if it is in line with accepted international practice,<sup>77</sup> then measures which the secured creditor will have to take in order to comply with this provision should be regarded as commercially reasonable. Keeping the aircraft in operation may mean that the secured creditor will have to obtain a licence or to employ a person who specialises in operating the aircraft, to purchase fuel, to pay landing, navigation fees as well as to incur other expenses. All such costs may be considered as commercially reasonable (since they are necessary to operate the aircraft) and added to the amount of the secured obligation or at least deducted from any profits made from the operation of the object which would, in general, go towards the discharge of the secured debt. But within these broad contours, there may be situations where some actions taken by the secured creditor may be challenged as not complying with the requirement of commercial reasonableness. For example, by analogy with the *Medforth* case, it may be argued that while the secured creditor undoubtedly needed to purchase fuel for the aircraft, it should have purchased it from the debtor's supplier in order to take advantage of a considerable discount which was always offered to it instead of buying the fuel elsewhere at full price. If the fuel comes in different types, it could be argued that instead of purchasing the best (and most expensive) type of available fuel, the secured creditor should have opted for the regular one which was usually used by the debtor. Also it may be argued that while it was necessary to insure the aircraft, there was no need to insure the aircraft against war and political risks as it was only intended to be operated in one or two countries which were known to be politically and economically stable. In relation to such situations, if it is not possible to find an answer through interpreting the security agreement, then the facts of particular

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<sup>76</sup> Art 8(3), the Convention.

<sup>77</sup> Goode (n 9) 182.

cases will have to be examined in order to establish whether all aspects of repossession were conducted in a commercially reasonable manner.

Another difficulty with the requirement of commercial reasonableness is that its boundaries are not precisely drawn. For example, the security agreement may state that it should not be commercially reasonable to simply store the repossessed aircraft in a hangar and that it should be operated instead. The aim of this requirement may be to prevent the aircraft from deteriorating and to earn sums which can be applied to reduce the secured debt. What if the security agreement states that if at the time of repossession the market conditions are such that the sale of the object would enable the secured creditor to extinguish most part of the debt, then it should not be commercially reasonable to operate it and the aircraft should be sold instead? The sale of the aircraft will save the secured creditor the costs associated with preserving and operating the aircraft. In addition, if sale is properly advertised and conducted, it could help to significantly reduce the debt. In other words, should the requirement of commercial reasonableness be interpreted narrowly, i.e. once the choice of the remedy is made, the secured creditor is required to exercise it in conformity with the set standard? Alternatively, does the requirement of commercial reasonableness mean that the choice of the remedy or remedies should also be made in line with this test?

The decision in *Palk and Another v Mortgage Services Funding Plc*,<sup>78</sup> may help to illustrate the point. In this case, the mortgagor was unable to pay the installments under the mortgage of its house and the mortgagee obtained an order for possession. The sale of the house would have enabled the mortgagor to repay most of the debt, but the mortgagee refused to sell it. Instead, the mortgagee wanted to let the house and wait until the market improved and a better price could have been obtained. The expected annual rent for the house would have been considerably less than the interest which could have been saved by selling the house. The question was whether the mortgagee could take possession and hold on to the house until the market improved or whether it should have sold it because sale would have enabled the debtor to repay most of the debt. It was held

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<sup>78</sup> [1993] Ch. 330.



that while, when exercising the remedies, the secured creditor was entitled to give preference to its own interest, it should keep the mortgagor's interest in mind too. The Court of Appeal directed a sale because the mortgagee's plan of letting the property would be too oppressive to the debtor and would lead to considerable increase of the debt. By analogy with this case, could it be argued that if the security agreement states that when market conditions are good, it should not be commercially reasonable to hold on to the repossessed aircraft and that the secured creditor should be required to sell it instead?

It is suggested that applying the requirement of commercial reasonableness at the stage of selection of remedy or remedies may be a step too far. First, the text of the Convention does not seem to support this view. It expressly provides that 'any remedy...shall be exercised in a commercially reasonable manner' and it does not require that the choice of remedy or remedies should also comply with this test. In addition, the Convention states that the secured creditor can exercise 'any one or more' of the remedies. Accordingly, the secured creditor should be able to decide on its own the exercise of which remedy would suit its interests best. Once the remedy is selected, for example, when the secured creditor takes possession of the object, it should do so in a commercially reasonable manner. This could mean that the secured creditor should take reasonable care in preserving the value of the object (which may involve renting the hangar, obtaining insurance, conducting necessary maintenance works etc.) and operating it, but should not require the exercise of other remedies. Secondly, requiring the secured creditor to exercise other remedies, once it takes possession of the object, may reduce the remedy of repossession into a mere precursor to other remedies. While in many cases the secured creditor will take possession in order to sell or lease the aircraft, this does not mean that the secured creditor should not be able to repossess the object for other purposes. An aircraft can fly into another jurisdiction in less than an hour and the secured creditor may need to repossess it in order to prevent it from moving into jurisdiction which may be hostile to the secured creditor's interests. In this case, the purpose of repossession may be to freeze the aircraft and not necessarily to sell it. If the debtor's financial position is such that it may be difficult for it to operate the object, the secured creditor may also wish to take possession of the aircraft in order to keep it earning sums which

can be applied to the reduction of the debt. In these cases, repossession may be temporary and the secured creditor may not intend to sell or lease the aircraft. Finally, if the requirement of commercial reasonableness is applied to the process of selection of remedies, it could lead to a discussion as to whether the secured creditor chose an appropriate remedy. For example, it may be argued that instead of selling the aircraft, the secured creditor should have leased it in order to allow the debtor to retain the ownership of the object. This may negate the idea that the secured creditor should be able to choose which remedy or remedies to exercise in the case of the debtor's default.

### 2.2.2 Selling or granting a lease of the charged object

#### a) Sale: public or private?

Following the debtor's default, the secured creditor can take possession and sell the object charged to it either in a public or private sale. Not all jurisdictions allow the secured creditor to sell the charged object in a private sale without obtaining a court order.<sup>79</sup> The main purpose of a public auction conducted under the supervision of the court or a notary is to protect the debtor from the creditor's abuse.<sup>80</sup> It is considered that if the secured creditor is allowed to sell the object without intervention of the court, it may sell it at a price which may be sufficient to repay the debt, but does not represent the true market value of the object. In this case the holders of subsequent international interests and the debtor will not be able to benefit from the sale.<sup>81</sup> Alternatively, the seller may sell a high value object at a reduced price (and repurchase it later in order to sell the object at a

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<sup>79</sup>This is often the case in civil law jurisdictions. See G Mauri, 'The Cape Town Convention on Interests in Mobile Equipment as Applied to Aircraft: Are Lenders Better off under the Geneva Convention?' (2005) 5 *European Review of Private Law* 641, 649. This is the position in Venezuela, Russia and Croatia. See H Gutierrez-Machado, 'The Personal Property Secured Financing System of Venezuela: A Comparative Study and the Case for Harmonization' (1998) 30 *U Miami Inter-Am L Rev* 343, 367-368; B Bennett, 'Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns' (1999) 77 *Tex L Rev* 1443, 1460; T Josipovic, 'The Rail Protocol and Croatian Secured Transactions Law' (2007) *Unif L Rev* 489, 506; In Germany the charged object can be sold at a public auction conducted by a neutral person, but no intervention of the court is generally required. See K Bismarck, *Secured Transactions in Remedies (Germany)* in I Fletcher and O Swarting (eds), *Remedies Under Security Interests* (London, Kluwer Law International 2002) 125.

<sup>80</sup> Mauri and Itterbeek (n 3) 553.

<sup>81</sup> *Ibid* 553.

profit) and claim the remainder of the debt from the debtor.<sup>82</sup> It is also considered that a public sale or auction can attract more bidders which can increase the price of the object.<sup>83</sup> Some jurisdictions have a scaling system of auctions: if the object is not sold at the first public auction at the price set by the court, the price can be reduced for the second auction and so on until a private sale is ordered.<sup>84</sup> All these measures mean additional costs and delays for both the secured creditor and the debtor and no guarantees that the object will be sold at a price representing its true market value.<sup>85</sup>

Other jurisdictions allow private sale of charged objects without court intervention and justify this approach in terms of speed, efficiency and lower costs with which the object can be repossessed and disposed of.<sup>86</sup> Despite these advantages, the secured creditor selling the object at a private sale may have to take into the account the risk that the sale may not be recognised in another country.<sup>87</sup> This may be particularly relevant in the case of aircraft sale because some jurisdictions require a certificate of deletion obtained with court's approval from the state where the aircraft was registered before it was sold.<sup>88</sup> If some of the aspects of the sale do not comply with the requirement of commercial reasonableness, a private sale may be challenged by the debtor. The secured creditor may also be liable under the sale agreement with the purchaser because private sale did not extinguish any prior encumbrances which weakened the purchaser's title to the object.<sup>89</sup> The Convention recognises that the approaches of various jurisdictions towards private or public sale of the repossessed object may be difficult and, possibly, unnecessary to reconcile. To this end, the requirement for the Contracting States to submit a declaration under Article 54(2) clarifying whether the remedies under the Convention, including sale of the object, could be exercised with or without leave of the court represents a practical solution balancing these approaches.

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<sup>82</sup> A Coles-Bjerre, 'Trusting the Process and Mistrusting the Results: A Structural Perspective on Article 9's Law-Price Foreclosure Rule' (2001) 9 Am Bankr Inst L Rev 351, 352-354.

<sup>83</sup> Zinnecker (n 59) 1153.

<sup>84</sup> Wood (n 8) 374.

<sup>85</sup> Ibid 373.

<sup>86</sup> H Gabriel, 'The New Zealand Personal Property Securities Act: A Comparison with the North American Model for Personal Property Security' (2000) 34 Int'l L 1123, 1130.

<sup>87</sup> Wood (n 8) 373.

<sup>88</sup> Ibid 373.

<sup>89</sup> Wood (n 8) 373-374.

b) The requirement of commercial reasonableness

As with all other remedies of the secured creditor, sale of the object must be conducted in a commercially reasonable manner.<sup>90</sup> As indicated above, the Convention does not define this requirement. But sale of the object will be deemed to have been conducted in commercially reasonable manner if it is conducted in conformity with a provision of the security agreement unless such a provision is manifestly unreasonable.<sup>91</sup> This means that the parties to the security agreement may specify how the sale should be handled in order to be commercially reasonable. The sale of the aircraft or railway object is likely to involve many stages, such as preparation of the object for sale, advertising in appropriate publications and negotiating the price. The costs associated with repossession of the object may also mean that the secured creditor will need to negotiate sale relatively quickly, but all aspects of sale must comply with the requirement of commercial reasonableness. The security agreement may address such issues as limited clean up and preparation of the object for the sale, content and types of publications where the sale should be advertised and time frame within which the secured creditor should be expected to sell the object.<sup>92</sup>

The cases decided in various jurisdictions may help to elucidate what factors of the sale may be important in considering whether it was conducted in commercially reasonable manner or whether it was manifestly unreasonable. For example in one case where the secured creditor advertised the sale of the repossessed Sabreliner 60 executive jet in the Wall Street Journal thirteen days before sale and in a well-known aircraft publication, Trade-a-Plane, five days before sale, this was not considered commercially reasonable.<sup>93</sup> The advertisement in the Wall Street Journal appeared in a general section as a public

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<sup>90</sup> Art 8(3) of the Convention stating that only the remedies set out in that Article (possession, sale, lease and collecting or receiving any income or profit arising out of management of the object) have to be exercised in commercially reasonable manner is modified by Aircraft, Rail and draft Space Protocols. According to these modifications, all remedies (and not only those mentioned in Art 8) of the secured creditor should be exercised in conformity with this standard. In contrast, the remedies of conditional seller or lessor to terminate the agreement and take possession of the object need not be exercised in a commercially reasonable manner. The reason why this requirement is absent in the case of these creditors is because by enforcing their remedies, conditional seller and lessor are simply exercising their rights to recover their own property.

<sup>91</sup> Art 8(3), the Convention.

<sup>92</sup> Zinnecker (n 59) 1153.

<sup>93</sup> *Connex Press v International Airmotive*, (1977) 436 Supp. 51, 22 UCC Rep. Serv. 1310, Civ. A. No 76-0538.

notice and not in the Aviation section which was usually used by the trade. The advertisement in the Trade-a-Plane was considered to be written in terms which were too cautious to encourage any interest from the buyers. But even if both advertisements complied with the stated requirements, this may still not have been enough, because in accordance with established practice among aircraft sellers, the secured creditor should have identified individual buyers and aircraft dealers who could potentially be interested in purchasing the aircraft and contacted them by mail or telegram.<sup>94</sup> In this case, the secured creditor had a mailing list of some 5,000 individuals, dealers and companies known to be interested in receiving notices of available jet aircrafts, but failed to contact potential buyers. In addition, the secured creditor took no steps to improve the appearance of the aircraft which could have been done by replacing eyebrow windows which were covered by insurance. The aircraft was kept at a secret location at a small out-of-the-way airport and a dealer who sought to inspect it prior to sale was refused the opportunity to do so. The secured creditor was the only bidder at the auction and bought the \$700,000 worth aircraft for only \$ 325,000: it was found that the sale was not conducted in a commercially reasonable manner.

This case demonstrates that such factors as advertisement of the sale, preparation of the aircraft for the sale, opportunity to inspect the aircraft and price of the sold object may be decisive in determining whether it was conducted in a commercially reasonable manner. In relation to advertising the sale, the notice of sale should target a public which is generally expected to be interested in the type of equipment which is offered for sale.<sup>95</sup> So, in addition to contacting potential buyers via mail, the secured creditor should consider placing a notice in specialist publications and not only in general newspapers.<sup>96</sup> The notice of sale should also be drafted in a way that would create interest among potential buyers so that the best possible price could be obtained for the object.<sup>97</sup> Another factor which may be relevant in considering whether the sale was commercially reasonable relates

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<sup>94</sup> As was the case in *Cessna Finance Corp. v Robert Wall*, (1994) 876 F. Supp. 273, 26 UCC Rep. Serv. 2d 637, No CA-93-77 ATH(Df), where the secured creditor contacted more than a hundred of potential buyers and sold the repossessed aircraft to the highest bidder.

<sup>95</sup> *Ford & Vlahos v ITT Commercial Finance Corp.* (1994) 8 Cal.4<sup>th</sup> 1220, 885 P.2d 877, 36 Cal.Rptr.2d 464.

<sup>96</sup> *Conrail Leasing Partners v Consolidated Airways* (1984) 742 F.2d 1095, 39 UCC Rep. Serv. 9; R Nowka, 'EBay Auctions of Repossessed Motor Vehicles – A Template for Commercial Reasonableness under Revised Article 9' (2007) 31 S Ill U L J 281, 299.

<sup>97</sup> *Villella Enterprises, Inc. v Young*, (1998) 108 N.M. 33, 766 P.2d 293.

to the preparation of the object for sale by improving its condition. The Convention does not require the secured creditor to repair or to make improvements to the object before it is sold. In this regard the question which may arise is whether the secured creditor should not only preserve, but also repair or improve the object if this would increase its price in order to comply with the requirement of commercial reasonableness. For example, if repainting the aircraft would considerably increase its price, should the secured creditor be required to do so in order to sell the object in commercially reasonable manner? The experience of different jurisdictions shows that it may not be advisable to impose such an obligation on the secured creditor.<sup>98</sup> While repairing the object may increase the likelihood of obtaining better price, this can hardly be guaranteed. There is a risk that the money put into repairs may not be recovered either at the sale of the aircraft or from the debtor.<sup>99</sup> The better approach may be to evaluate whether the benefits which can be obtained as a result of the preparation of the object are likely to outweigh the costs of the work.<sup>100</sup> For example, if the secured creditor discovers that the repossessed aircraft is not in a condition to fly, it may be commercially reasonable to disassemble its wings for easier transportation and sell it in parts.<sup>101</sup> Although it may be argued that the disassembled aircraft will cost considerably less than a whole one, the cost of repairing the repossessed aircraft may outweigh the potential benefit of the preparation of the object for sale. If the estimated cost of repair is around \$8,000 and the plane's value in its current condition is around \$6,100, repairing the aircraft may not be commercially reasonable and it should be sold in its present condition.<sup>102</sup> Providing potential buyers with an opportunity to inspect the object as well as presenting log books and airworthiness certificates and other documents may also be a relevant

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<sup>98</sup> For example, English law only requires the secured creditor to preserve, but not to improve the object before selling it. See *Garland v Ralph Pay & Ransom* [1984] 2 EGLR 147, 151; *Silven Properties Ltd v Royal Bank of Scotland Plc* [2003] EWCA Civ 1409. S 9-610(a) Art 9 UCC states that the secured creditor may dispose of the object in its present condition or following any commercially reasonable preparation or processing. This means that the secured creditor is not obliged to repair or improve the object and can, in principle, dispose of it in its present condition. But if it may be commercially reasonable, some preparation of the object may be undertaken before disposing of it. The creditor is encouraged to evaluate possible benefits and costs of repair works and to consider whether the benefits of preparing the object for sale are likely to outweigh the costs of the work that needs to be done. See Zinnecker (n 59) 1151.

<sup>99</sup> *White and Summers* (n 57) 908.

<sup>100</sup> Zinnecker (n 59) 1151.

<sup>101</sup> *Grumman Credit Corporation v Rivair Flying Service*, (1992) 845 P.2d 182, 18 UCC Rep. Serv. 2d 978.

<sup>102</sup> *Ibid* 186.

consideration when deciding whether the sale of the object is conducted in a commercially reasonable manner.<sup>103</sup> Where the secured creditor refuses to start the engines or to demonstrate the documents relating to the aircraft,<sup>104</sup> or where it hides the aircraft to prevent its inspection,<sup>105</sup> this may avert potential buyers and adversely affect the price of the object. A sale conducted in such circumstances may be challenged on the grounds of commercial reasonableness.

Another factor which may be relevant in considering whether the sale was conducted in commercially reasonable manner relates to the timing of the sale. Selling the repossessed aircraft worth over \$2.64m within two weeks of marketing to a purchaser described by the secured creditor's representative as a 'true bottom fisher' for only \$2m to prevent a negative impact on a secured creditor's history of loan performance may be considered as not complying with the requirement of commercial reasonableness.<sup>106</sup> At the same time, waiting too long may also be a mistake.<sup>107</sup> The best guide in relation to the time which may be required to make a commercially reasonable sale may be the nature of the object and the conditions of the market.<sup>108</sup> The types of equipment covered by the Convention and the Protocols are high value and bulky and it may not be easy to sell such objects quickly. Given the fact that aircraft, railway and space equipment can be exceptionally expensive, the circle of potential buyers of such objects may be limited. If the industry is going through a recession, this too may affect the purchase capacity of potential buyers. In such a case it may take time to find a suitable buyer and rushing the sale may not be commercially reasonable.<sup>109</sup> Finally, the single most important indicator of commercially reasonable sale is probably the price at which the object is sold.<sup>110</sup> If the secured creditor is the only

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<sup>103</sup> Ibid 186.

<sup>104</sup> *Sunjet Inc v Ford Motor Credit*, (1985) 703 S.W. 2d 285.

<sup>105</sup> *Connex Press v International Airmotive*, (1977) 436 Supp. 51, 22 UCC Rep. Serv. 1310, Civ. A. No 76-0538.

<sup>106</sup> *Aviation Finance Group v DUC Housing Partners*, (2010) WL 1576841 (D. Idaho) 72 UCC Rep. Serv. 2d 583.

<sup>107</sup> *Harris v Bower*, (1972) 266 Md. 579, 295 A.2d 870, 55 A.L.R.3d 640, 11 UCC Rep.Serv. 428. In this case the creditor permitted the repossessed boat to depreciate for two yachting seasons before selling it which was not commercially reasonable.

<sup>108</sup> *In re Concord Coal Corporation*, (1988) 81 B.R. 863, 6 UCC Rep.Serv. 2d 1646.

<sup>109</sup> *Nelson v Armstrong*, (1978) 99 Idaho 422, 582 P.2d 1100, 24 UCC Rep.Serv. 1378; *John Deere Leasing Company v Fraker*, (1986) 395 N.W. 2d 885, 2 UCC Rep.Serv. 2d 1152.

<sup>110</sup> This appears to be the position under Canadian Personal Property Security Act. See J Sandrelli, C Ramsay, A Bahadoorsingh, 'Remedies under Security Interests in Canada: An Overview' in Fletcher and Swarting (n 79) 80.

bidder and buys the repossessed aircraft for \$1m only to resell it later at \$1.5m, this is unlikely to amount to a commercially reasonable sale.<sup>111</sup> At the same time, price should not be the only factor and other aspects of sale should be taken into consideration when examining the matter: the mere fact that a higher price could have been obtained should not necessarily mean that the sale was not commercially reasonable.<sup>112</sup>

c) Lease and management of the object

Instead of selling the repossessed object, the secured creditor may grant a lease over it and apply any rental payments to the reduction of the amount of the secured debt.<sup>113</sup> Alternatively, the secured creditor may repossess the object and keep it in service or manage it in another way and collect any income or profits arising from its management in order to reduce the debt.<sup>114</sup> The exercise of these remedies means that although the debtor will be dispossessed of the object, it will retain ownership over it and, once the debt is repaid, can resume its possession. Similar to other remedies of the secured creditor, leasing and management of the object should be exercised in a commercially reasonable manner.<sup>115</sup> The lease and management are deemed to be exercised in a commercially reasonable manner if they are exercised in conformity with the provision of the security agreement unless such a provision is manifestly unreasonable.<sup>116</sup> When repossessing the object, the secured creditor may find that it is already leased out by the debtor. If the interest of the secured creditor was registered before that of the debtor/lessor,

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<sup>111</sup> *Ford & Vlahos v ITT Commercial Finance Corp.* (1994) 8 Cal.4<sup>th</sup> 1220, 885 P.2d 877, 36 Cal.Rptr.2d 464. The Convention does not preclude the secured creditor from purchasing the collateral provided that the sale is conducted in a commercially reasonable manner. See Goode (n 9) 42. In contrast, English law does not allow the secured creditor to sell the collateral to itself as this may create possible conflict of interests. At the same time, the mortgagee may be able to sell the collateral to a company in which it has interest. In this case the mortgagee or the company has to show that it took reasonable steps to obtain best possible price for the object. See *Martinson v Clowes* (1882) 21 Ch. D. 857; *Tse Kwong Lam v Wong Chit Sen* [1983] 1 W.L.R. 1349, 1355 per Lord Templeman; See also *Alpstream AG v PK Airfinance Sarl* [2011] EWHC 1002 (Comm) stating that where repossessed aircraft were sold to a company connected to the mortgagee, the latter had to prove that it obtained the best possible price.

<sup>112</sup> *Parker-Tweedale v Dunbar Bank Plc. and Others* [1991] Ch. 12; Beale, Bridge, Gullifer, Lomnicka (n 30) 635.

<sup>113</sup> Art 8(1)(b), the Convention. See Goode (n 9) 42.

<sup>114</sup> Art 8(1)(c), the Convention. See Goode (n 9) 42.

<sup>115</sup> Art 8(3), the Convention.

<sup>116</sup> Art 8(3), the Convention.



it will prevail over the interest of the lessee.<sup>117</sup> In this case, the secured creditor may either terminate the existing lease in order to grant a new one or allow the lease to continue provided that the rental payments are paid to it (and applied to satisfaction of the secured debt). In making this decision, the secured creditor will need to exercise commercial reasonableness which may involve assessment of costs associated with termination of the existing lease and finding a new lessee. Finally, leasing of the object may be precluded if the object is situated on the territory of a Contracting State which made a declaration to this effect.<sup>118</sup>

#### d) Notice of proposed sale or lease

##### Purpose of notice

The secured creditor proposing to sell or grant a lease of the object should give reasonable prior notice in writing to interested persons informing them of the proposed disposition.<sup>119</sup> In contrast, there is no need to send such a notice if the secured creditor proposes to exercise other remedies, such as to repossess or collect or receive any income or profit arising from the management or use of the object. The reason why the Convention requires the secured creditor to inform interested persons about the proposed sale or lease is because their position is likely to change as a result of such exercise of remedies.<sup>120</sup> So the main purpose of the notice is to warn interested persons about these changes and to give them time to protect their interests in the object. If the debtor is informed of the proposed sale of the object it can obtain finance from elsewhere and redeem the object to prevent its loss.<sup>121</sup> If this is not possible, it can contact other interested persons who may be ready to pay the amount of the secured debt in full to the secured creditor. After the debt is repaid, such interested person will be subrogated to the rights of the secured creditor.<sup>122</sup> This can also help the debtor to retain its interest in the object. An informed debtor may actively participate in the sale and purchase the object itself.<sup>123</sup> If the sale is unavoidable, the debtor may suggest any potential

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<sup>117</sup> Art 29(4), the Convention.

<sup>118</sup> Art 54(1), the Convention. To this date (April, 2011) only China has made such a declaration.

<sup>119</sup> Art 8(4), the Convention.

<sup>120</sup> Goode (n 9) 182.

<sup>121</sup> *Deere Credit v Lowell Quarries*, (2002) F.Supp.2d, 2002 WL 1632444 (N.D. Ill.), 48 UCC Rep.Serv. 2d 40.

<sup>122</sup> Art 9(4), the Convention.

<sup>123</sup> *Siemens Credit v Marvik Colour*, (1994) 859 F.Supp.686, 24 UCC Rep.Serv.2d 705 692.

buyers which may help to secure the best possible price for the object. The notice informing the debtor (and other interested persons) about the proposed disposition may also provide them with opportunity to ensure that the sale or lease is conducted in a commercially reasonable manner.<sup>124</sup> This may be beneficial to the secured creditor as monitoring of commercial reasonableness of sale or lease by the debtor may prevent it from challenging disposition of the object at a later stage.<sup>125</sup> Similarly, lease of the object may change the debtor's position because it will be dispossessed of the object for its duration. For this reason, it should be given an opportunity to protect its interest in the object.

#### The recipients of notice

The secured creditor is required to send the notice of proposed sale or lease to interested persons, a notion which is only relevant for the part of the Convention which deals with the remedies available to the creditor. Unless the secured creditor obtains a court order, it will need the agreement of interested persons in order to vest in itself the interest of the debtor held by it in the object in or towards satisfaction of the debt.<sup>126</sup> When granting a speedy relief order, the court may impose any terms which it considers necessary to protect interested persons from the creditor's misbehavior.<sup>127</sup> The court may also require that a notice is given to interested persons informing them of the request of the speedy relief made by the creditor.<sup>128</sup>

There are three categories of interested persons<sup>129</sup> and this is relevant because while some of them are entitled to receive the notice of proposed sale or lease, others may only expect such notice if they inform the secured creditor about their rights in the object within a reasonable time prior to the sale or lease.<sup>130</sup> The debtor, i.e. the chargor under the security agreement, the conditional buyer under the title reservation agreement and the lessee under the leasing agreement, are in

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<sup>124</sup> Zinnecker (n 59) 1160.

<sup>125</sup> Another reason is that notice of the proposed sale may help the debtor to decide when to file a bankruptcy petition to prevent it. See R Lloyd, 'The Absolute Bar Rule in UCC Foreclosure Sales: A Prescription for Waste' (1993) 40 UCLAL Rev 695, 715-20.

<sup>126</sup> Art 9, the Convention.

<sup>127</sup> Art 13(2), the Convention.

<sup>128</sup> Art 13(3), the Convention.

<sup>129</sup> Art 1(m), the Convention.

<sup>130</sup> Art 8(4), the Convention.

the first category of interested persons.<sup>131</sup> But the debtor also includes a person whose interest in the object is burdened by a registrable non-consensual right or interest under Article 40.<sup>132</sup> It may not be immediately clear who is this person. It should be somebody who already has an interest in the object and that interest is burdened by the registrable non-consensual right or interest. Accordingly, it cannot be the holder of such right or interest, but can be either the primary debtor or a holder of another international interest whose interest is subsequent to the registrable non-consensual right or interest and, for that reason, is burdened by it. Since the primary debtor, i.e. the chargor, conditional buyer and lessee, is defined separately, this means that the person whose interest is burdened by such right or interest may be the holder of subsequent or subordinated international interest.

For example, if the chargor grants a security interest in the aircraft to SC1, a registrable non-consensual right or interest to C2 and another security interest to SC3, then the chargor and SC3 will be considered as debtors and will be entitled to receive the notice of proposed sale or lease as interested persons. In contrast, SC1 will not be considered as the debtor or other interested person falling into the first category. The consequence of the distinction between the holder of the international interest whose interest is or is not burdened by the registrable non-consensual right or interest is that the former (but not the latter) will be among those interested persons who are entitled to receive notice of proposed disposition. If its interest is not so burdened, the holder of the international interest will fall into the third category of interested persons and will only be entitled to the notice if it informs the secured creditor of its interest in the object.<sup>133</sup> The second category of interested persons include those persons who, for the purpose of assuring performance of the obligation, give or issue a suretyship or demand guarantee or a standby letter of creditor.<sup>134</sup> Finally, a third category includes any other persons having rights and interests in the object.<sup>135</sup> This category is very wide and includes senior and junior secured creditors, as well as holders of other

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<sup>131</sup> Art 1(j), the Convention.

<sup>132</sup> Art 1(j), the Convention.

<sup>133</sup> The purpose of the distinction may be questionable, since in the majority of cases, the holder of the international interest which is not burdened by the registrable non-consensual right or interest will register its interest in the International Registry. This is likely to amount to the notice of the interest which needs to be sent to the selling secured creditor. As a result, the secured creditor will have to send the notice of the proposed disposition to it anyway.

<sup>134</sup> Art 1(m)(ii), the Convention.

<sup>135</sup> Art 1(m)(iii), the Convention.

interests which can be registered in the International Registry.<sup>136</sup> Even the holders of interests which are not so registered may fall into this category.<sup>137</sup> The interested persons of the third category are not automatically entitled to receive the notice of proposed sale or lease from the secured creditor. They can only expect such notice if they themselves notify the secured creditor about their interests in the object within a reasonable time prior to the sale or lease. The registration of such interests in the International Registry will probably amount to such notice.<sup>138</sup>

The Convention does not define what amounts to a reasonable time prior to the sale or lease during which the interested person should notify the secured creditor about its interest in the object and this is likely to be a question of fact. In contrast, the Aircraft Protocol specifies that the secured creditor giving ten or more working days' prior written notice of the proposed sale or lease to interested persons shall be deemed to satisfy the requirement of providing 'reasonable prior notice'.<sup>139</sup> Similarly, under the Luxembourg Protocol, the secured creditor is required to give fourteen or more calendar days' prior written notice to the interested persons in order to satisfy the requirement of prior reasonable notice of sale or lease.<sup>140</sup> Finally, there is no need to use a particular language or include certain information into the notice. In fact, the content of the notice is not specified in the Convention and the Protocols. It is suggested that it should include the names of the selling secured creditor and the debtor or other interested persons, to identify the object which is about to be sold or leased as well as the date, location and manner of the proposed disposition.

e) Consequences of not complying with the requirements of commercial reasonableness and notice

The main purpose of the requirements of commercial reasonableness and notice of proposed sale or lease is to protect the debtor from the creditor's misbehavior. If the sale is conducted in a commercially reasonable manner, the debtor may be certain that the secured creditor put every effort in obtaining the best possible

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<sup>136</sup> Goode (n 9) 159.

<sup>137</sup> Ibid 159.

<sup>138</sup> Ibid 182.

<sup>139</sup> Art IX(4), the Aircraft Protocol.

<sup>140</sup> Art VII(4), the Luxembourg Protocol.

price for the object. Similarly, if the object is leased in a commercially reasonable manner, the debtor may be assured that the secured creditor will obtain adequate rental payments and that the ownership of the object will remain with the debtor. The debtor will primarily be interested in the amount of sums received as a result of sale or lease of the object because these sums will be applied towards discharge of the secured debt. If such sums are not sufficient to discharge the debt, the debtor will have to pay the deficiency to the secured creditor. If sale or lease of the object generates any surplus, this may help the debtor to discharge any secured debts which it owes to subsequent secured creditors and, possibly, even retain the remainder. As noted above, the main purpose of the requirement of prior notice of proposed sale or lease is to warn the debtor and interested persons that the nature of their interests in the object is about to change.

Protection of the debtor's interest in the object depends on the secured creditor's compliance with the requirements of commercial reasonableness and notice. But the Convention does not expressly state what the consequences of non-compliance with these requirements are. In essence, the debtor appears to have a right without a remedy: should the secured creditor exercise a remedy in a way which may be manifestly unreasonable (for example, by leaving the repossessed aircraft at the airfield to depreciate instead of transporting it elsewhere for safe storage) or fail to notify the debtor of proposed sale, the debtor appears not to have any remedy against the secured creditor under the Convention. It may be argued that the Convention does not govern this issue and that the debtor should proceed against the secured creditor under the applicable law. At the same time, if this matter is delegated to the applicable law, then the very existence of the requirements of commercial reasonableness and notice under the Convention may well be questioned. The effect of the Convention and the Protocols is that all remedies of the secured creditor should be exercised in a commercially reasonable manner. Surely, if the Convention imposes such an obligation on the secured creditor, it should provide for the consequences of failure to observe this requirement? If this matter is governed by the Convention, but is not expressly settled in it than it should be settled in conformity with the general principles on which the Convention is based.<sup>141</sup> Before exploring if there

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<sup>141</sup> Art 5(2), the Convention.

are any general principles capable of resolving this issue and, more broadly, before considering how the problem of the consequences of non-compliance is to be tackled under the Convention, it may be helpful to gain an insight into the relevant experience of some domestic legal systems. Under English law the mortgagee is not required to exercise its remedies in a commercially reasonable manner or to exercise them at all. Subject to the duty of good faith, the mortgagee can decide in accordance with its own interest whether and when to sell the object even if its decision may have an adverse effect on the position of the mortgagor.<sup>142</sup> But when the mortgagee decides to sell, it owes an equitable duty to the mortgagor and subsequent encumbrances to take reasonable care in obtaining true market value of the property on the date of sale.<sup>143</sup> What amounts to the exercise of the duty will depend on the circumstances of each case, but, generally, the result achieved by this requirement appears to be similar to the one intended under the Convention: to obtain true market value of the object, the mortgagee should ensure that the sale is advertised in a suitable publication<sup>144</sup> which draws to the attention of potential buyers any specific features which may affect the price.<sup>145</sup> Similarly, the mere fact that a higher price could have been obtained does not mean that there is a breach of the duty as long as the price is a 'proper price'.<sup>146</sup>

In one case the court found that the mortgagee breached its duty to take reasonable care to obtain true market value of the property because the sale of the building was not adequately advertised and the building was sold to the wife of the mortgagee who was the only bidder at the auction with reserved price.<sup>147</sup> Although there is no fixed rule that the mortgagee cannot sell the mortgaged property to the company in which it has interest, the close relationship between

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<sup>142</sup> Beale, Bridge, Gullifer, Lomnicka (n 30) 634; *Cuckmere Brick Co v Mutual Finance* [1971] Ch. 949.

<sup>143</sup> *Cuckmere Brick Co v Mutual Finance* [1971] Ch. 949, 965, 972, 977.

<sup>144</sup> *American Express International Banking Corporation v Hurley* [1986] BCLC 52, the case involving the breach of duty where the mortgagee failed to obtain advice and advertise music equipment in a specialist publication.

<sup>145</sup> *Cuckmere Brick Co v Mutual Finance Ltd* [1971] Ch. 949, where the breach of duty consisted in failing to draw to the attention of potential buyers the fact that a planning permission for building of flats was obtained in relation to the mortgaged land, which could have increased its price.

<sup>146</sup> Beale, Bridge, Gullifer, Lomnicka (n 30) 635; *Parker-Tweedale v Dunbar Bank Plc* [1991] Ch. 12.

<sup>147</sup> *Tse Kwong Lam v Wong Chit Sen and Others* [1983] 1 W.L.R. 1349.

the mortgagee and the purchaser made it necessary for the mortgagee to show that it had taken reasonable precautions to obtain the best price. The consequence of non-compliance with this duty meant that the sale could be set aside. However, on the facts of the case, this could not be achieved because of the mortgagor's own failure to bring the action sooner. Some thirteen years elapsed before the dispute came for consideration before Privy Council and it was held that the sale could no longer be set aside. Instead, the mortgagor was entitled to damages measured as the difference between the best price which could have been obtained at the date of sale and the price paid by the purchaser.

Should a similar approach be adopted when dealing with the consequences of non-compliance with the requirements of commercial reasonableness and notice under the Convention? For example, if the secured creditor sells the repossessed train wagon to a company in which it has an interest for \$1.5m and that company resells it a week later for \$3m, the sale could be held not to have been conducted in a commercially reasonable manner. Should the debtor be entitled to apply to a court in order to set the sale aside? The sale could be set aside provided that the debtor is able to redeem the object, in which case the train wagon could be returned to it. Although this approach could work well when applied to these particular facts, it may not be suitable in the context of the Convention. The cost of the types of the equipment covered by the Convention and the Protocols can be exceptionally high and the prospect of losing the object because the sale can be set aside due to the secured creditor's non-compliance with the requirements of the Convention may avert potential purchasers from buying the object. The circle of individuals and companies who could be interested and able to purchase aircraft, railway and space objects is limited and the prospect of losing the object after great expense may have been incurred to transport the railway object to the jurisdiction of the purchaser's choice, to launch the aircraft into the sky or a satellite into space may seem too burdensome to potential buyers. This approach may also run counter to the policy of making asset-based financing cheaper and more easily available: allowing the secured creditor to sell or lease the object without leave of court may help it yield greater sums relatively quickly. This may reduce the risk of non-repayment of the debt which may allow the secured creditor to charge a lower interest rate on the loan.

Providing the debtor with the opportunity to set the sale aside may make the realisation of the object more onerous. In addition, if the purchaser cannot be certain that it will not be involved in litigation over the title to the object, the purchase price of the object may have to be reduced.

Next, the purchaser may relocate the aircraft or railway object into a different jurisdiction where enforcement of a court order to set the sale aside may be difficult to implement. The decision to set the sale aside may also be subject to various limitation periods under the applicable law. Finally, setting the sale aside may be too harsh if the non-compliance with the requirements of the Convention is minor. For example, if the secured creditor failed to notify the debtor of the proposed sale, but the price obtained for the object represents its true market value which is sufficient to discharge the debt, disturbing the sale could be too harsh. This could be particularly the case if the debtor's financial situation is such that it would not be able to obtain fresh loan to redeem the object.

In contrast, an approach which does not affect the position of a third party purchaser may be more attractive. For example, if setting the sale aside would be inequitable as between the debtor and the purchaser, the debtor could still be entitled to damages<sup>148</sup> resulting from the loss suffered by it due to the secured creditor's non-compliance with the requirements of commercial reasonableness or notice. This could also better reflect the nature of the loss suffered by the debtor. For instance, in the above example, the debtor may not have suffered any loss as a result of the secured creditor's failure to notify it of the proposed sale as it would not have been able to redeem the property in any event. If the view that damages represents a viable and practicable solution to the problem of consequences of non-compliance gains support, the question will arise whether a remedy of damages can be developed within the Convention or whether a damages claim will have to and can be brought under the applicable domestic law. As things stand, there is nothing in the Convention indicating the availability of this remedy.

Similar to the Convention, Article 9 UCC<sup>149</sup> requires that every aspect of the disposition of collateral, including the method, manner, time, place, and other

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<sup>148</sup> Tse Kwong Lam v Wong Chit Sen and Others [1983] 1 W.L.R. 1349, 1359-60.

<sup>149</sup> S. 9-610(b).



terms, must be commercially reasonable.<sup>150</sup> But while Article 9 requires the secured creditor to notify the debtor and to dispose of the object in a commercially reasonable manner, its earlier versions did not expressly provide what consequences might follow if it failed to comply with this standard.<sup>151</sup> This resulted in the development of three different approaches to this issue.<sup>152</sup> Each of these approaches may have a varying effect on the secured creditor's right to claim deficiency. If the object is sold, but the proceeds of sale are not sufficient to discharge the secured debt, the secured creditor may be entitled to claim the remainder from the debtor until the whole debt is repaid. However, the right of the secured creditor to claim the deficiency may be affected if it does not comply with the requirement of commercial reasonableness when disposing of the object or serving the notice to the debtor. Under the first approach, non-compliance with the requirement of commercial reasonableness could absolutely bar the secured creditor from obtaining the deficiency. If the secured creditor disposed of the object at a significantly lower price (compared to the price at which it was only recently purchased) at a poorly advertised auction, it could be barred from recovering the remainder of the debt from the debtor.<sup>153</sup> Since this consequence followed regardless of the nature of the non-compliance with the requirement of commercial reasonableness it was thought to be too harsh on the secured creditor.<sup>154</sup> Debarring the secured creditor from the deficiency could also result in a windfall on the debtor.<sup>155</sup>

Under the second approach, the secured creditor could obtain the deficiency irrespective of the breach of the requirement of commercial reasonableness, but

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<sup>150</sup> S. 9-627(a) states that the fact that a greater amount could have been obtained by collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that it complied with the requirement of commercial reasonableness. Nonetheless, the price at which the object is sold is often considered as one of the most significant aspects of commercially reasonable disposition. See *White and Summers* (57) 904; *Aviation Finance Group v DUC Housing Partners*, (2010) WL 1576841 (D. Idaho) 72 UCC Rep. Serv. 2d 583.

<sup>151</sup> *Ruden v Citizens Bank and Trust Company of Maryland*, (1994) 99 Md. App. 605, 638A.2d 1225, 23 UCC Rep.Serv.2d 623.

<sup>152</sup> For a discussion of these approaches see *Siemens Credit v Marvik Colour*, (1994) 859 F.Supp.686, 24 UCC Rep.Serv.2d 705.

<sup>153</sup> *Central Budget Corp. v Garrett*, (1975) 48 A.D.2d 825, 368 N.Y.S.2d 268, 17 UCC Rep.Serv. 327.

<sup>154</sup> For a detailed discussion of this approach see *Lloyd* (n 125) 745.

<sup>155</sup> For these reasons, the absolute bar rule was ultimately rejected. See *White and Summers* (n 57) 915.

this was subject to a reduction for damages suffered by the debtor.<sup>156</sup> The difficulty with this approach is that it places the burden of proof of the damage suffered as a result of non-compliance on the debtor who may find it difficult to establish that the disposition was not commercially reasonable.<sup>157</sup> Finally, a third approach, which is currently accepted under the UCC, is the rule of the rebuttable presumption.<sup>158</sup> According to this rule, the non-complying secured creditor can still recover a deficiency, but only if it can rebut the presumption that the value of the collateral was equal to the debt. An example may help to demonstrate how the rule operates. Assume that the amount of the secured debt is \$280m and that the sale of the repossessed aircraft only brought \$100m. If the sale was conducted in a commercially reasonable manner and the secured creditor complied with the requirements of notice, it should be able to recover the remainder of the debt in full (so, \$180m). If the sale did not comply with the set requirements, the presumption is that the sum which would have been obtained at a commercially reasonable sale equals the amount of the secured debt, which would be \$280m. This means that the secured creditor cannot claim any deficiency from the debtor. The presumption may be rebutted, if the secured creditor can show that even if it complied with the requirements of commercial reasonableness and notice, the sale of the object could not have brought the full amount of the secured debt. For example, if the secured creditor can show that at a commercially reasonable sale the aircraft could have been sold for \$120m, it should be able to claim the remaining \$160m from the debtor. By proving the amount which a commercially reasonable sale of the object could have brought the secured creditor can rectify its own non-compliance. Since the rule places the burden of proof on the secured creditor, it can serve as an adequate deterrent aimed at preventing a commercially unreasonable sale.<sup>159</sup> This means that the debtor's interest can be protected. At the same time, the secured creditor can still claim the remainder of the debt from the debtor.

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<sup>156</sup> *Associates Capital v Riccardi*, (1978) 454 F.Supp. 832, 24 UCC Rep.Serv. 1359, 835; *Flickinger Co v 18 Genesee Corporation*, (1979) 71 A.D. 2d 382, 423 N.Y.S.2d 73, 27 UCC Rep.Serv. 1232.

<sup>157</sup> *Ruden v Citizens Bank and Trust Company of Maryland*, (1994) 99 Md. App. 605, 638A.2d 1225, 23 UCC Rep.Serv.2d 623, at 1230.

<sup>158</sup> *White and Summers* (n 57) 915.

<sup>159</sup> *Ruden v Citizens Bank and Trust Company of Maryland*, (1994) 99 Md. App. 605, 638A.2d 1225, 23 UCC Rep.Serv.2d 623, at 1232.

The next question is whether, taking into consideration the general principles on which the Convention is based, a similar approach should be developed within its framework in order to deal with the consequences of non-compliance with the requirements of notice and commercial reasonableness. One of the attractions of the rebuttable presumption rule is that the dispute about the consequences of non-compliance with the requirements of the Convention is confined to the parties who are immediately affected by them, i.e. the debtor and the secured creditor. Even if the sale of the aircraft is not commercially reasonable, it is not invalidated and the purchaser can rest assured that once the purchase price is paid, it can safely include the aircraft to the rest of its fleet. This means that the price which can be obtained for the repossessed aircraft will not be adversely affected by the prospect that the sale can later be set aside. This, in turn, can assure the secured creditor that it will be able to obtain a proper price for the object and that the debt can be repaid out of proceeds of sale which should induce it to lower the interest rate on the loan. This result would accord with one of the main economic goals of the Convention, i.e. to reduce the cost of borrowing against equipment and to make secured financing more readily available. This is also in line with the principle of predictability on which the Convention is based.<sup>160</sup> If the rule of rebuttable presumption could be developed under the Convention, it would clarify what consequences may follow if the secured creditor does not comply with the requirements of notice and commercial reasonableness. This approach can also be in line with the general principle of practicality under the Convention as it can encourage the secured creditor to put every effort into obtaining the best possible price for the repossessed object in order to avoid litigation and risk the reduction of the deficiency.

The difficulty with the rebuttable presumption rule is that it targets the availability and amount of deficiency which the secured creditor can claim from the debtor - a concept which is not expressly mentioned in the Convention. To prevent the secured creditor from receiving a windfall as well as to underline the accessory nature of the security interest, any sum collected by it as a result of the exercise of the remedies should be applied towards discharge of the debt.<sup>161</sup> Any

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<sup>160</sup> Of course, this would be true of any rule adopted under the Convention to tackle the issue of consequences of non-compliance with the requirements of commercial reasonableness and notice.

<sup>161</sup> Art 8(5), the Convention. See Goode (n 9) 182.

surplus which may remain after the discharge of the secured obligation and reasonable costs incurred in the exercise of the remedies should be distributed among holders of subsequent international interests and the debtor.<sup>162</sup> But it is not clear what should the secured creditor do if the amount which is obtained as a result of the exercise of the remedies is not enough to discharge the obligation. First, it may be suggested that the secured creditor's claim should be based on the very notion of the debt: it continues to exist until fully discharged. If the amount which is received as a result of sale of the repossessed object is not enough to repay the debt, then it is merely reduced by such amount, but continues to exist until the remainder of the debt can be received. Secondly, some support for the view that the secured creditor should be able to claim deficiency from the debtor can be found in the wording of Article 8(5) of the Convention which states that 'any sum collected...as a result of exercise of...the remedies... should be applied towards discharge' of the debt. This wording suggests that the sum so received should be used as a contribution to the reduction of the amount of the debt. If the sum is enough to extinguish the debt, it should be fully applied for this purpose. The remainder (if any) should be distributed among holders of subsequent international interests and the debtor. If, however, this sum is not sufficient to discharge the obligation, then it should still be fully applied to the discharge of the debt, but this does not extinguish the debt. The secured creditor should be able to claim the remaining sum from the debtor until the whole debt is repaid.

This analysis can be supported by the wording of Article 9(1) of the Convention which states that, provided that all interested persons agree, the object covered by the security interest can 'vest in the secured creditor in or towards satisfaction of the secured obligation.' This may mean that if the object is transferred to the secured creditor in satisfaction of the debt, then the debt is fully discharged. In contrast, if the object is transferred towards satisfaction of the debt, then the discharge is only partial and the secured creditor should be able to claim the remaining part of the debt. Alternatively, the secured creditor can claim the deficiency from the debtor if this remedy is permitted by the applicable law and is not inconsistent with the Convention.<sup>163</sup> For these reasons it is tentatively

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<sup>162</sup> Art 8(6), the Convention.

<sup>163</sup> Art 14, the Convention.

suggested that, first of all, the deficiency can be claimed under the Convention as it naturally flows from the nature of the debt as is supported by the text of the Convention. Secondly, the rebuttable presumption rule which deals with consequence of non-compliance is an approach which would more effectively (than other considered alternatives) promote and implement the Convention's policies and aims. The Convention's general principles also lend ample support for the development of such a rule. Finally, damages may potentially be an effective and practicable solution along with the rebuttable presumption rule. However, as noted above, it is far from clear how and on what basis the remedy of damages could be invoked and applied.

#### f) Application of proceeds and surplus

Whether the secured creditor takes possession, sells, leases, manages or uses the object, it does not deal with it as its owner. For this reason, any sum which may be received or collected by the secured creditor when exercising its remedies should be applied towards the discharge of the amount of the secured obligation.<sup>164</sup> The sale of the object extinguishes the interest of the debtor and any interested persons in it and their only claim is against proceeds of sale.<sup>165</sup> If the sums collected or received by the secured creditor exceed the amount of the secured debt and any reasonable expenses associated with the exercise of remedies, the secured creditor should distribute the surplus among holders of subsequent international interests in order of priority and pay any remainder to the debtor.<sup>166</sup>

### 2.2.3 Vesting of object in satisfaction; Redemption

#### a) Purposes and effect

In some cases the secured creditor may decide that taking possession and selling the object may not be financially expedient.<sup>167</sup> When the industry is going through a recession, selling the aircraft may mean that only a fraction of its value can be realised. At such times, the amount of debt may exceed the value of the object, but the secured creditor may wish to accept the aircraft in full or partial satisfaction of

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<sup>164</sup> Art 8(5), the Convention.

<sup>165</sup> Art 9(4), the Convention.

<sup>166</sup> Art 8(6), the Convention.

<sup>167</sup> White and Summers (n 57) 899.

the secured obligation in the hope that it will be able to sell the object at a profit when market improves. The effect of accepting the object in satisfaction of debt is that the debtor's opportunity to redeem it is extinguished.<sup>168</sup> This means that if the secured creditor later sells or leases the object, it is not under an obligation to account to the debtor for any surplus or rental payments resulting from its sale or lease.<sup>169</sup> Under the Convention, vesting of an object in satisfaction of the debt is final and cannot be opened by the debtor even if it later offers to repay the debt in full.<sup>170</sup> This can bring certainty for the purchaser from the secured creditor since it will not have to be concerned with possible challenges to its title to the object.<sup>171</sup> As a result, the secured creditor may be able to sell the aircraft at a better price. Because of the severe effect of the remedy on the debtor and its other creditors, many jurisdictions either forbid it or only allow its exercise under court supervision and provided that all persons who may be affected by it are made parties to the proceedings.<sup>172</sup> In contrast, the Convention permits the exercise of this remedy either extra judicially or on obtaining a court order.<sup>173</sup>

#### b) Exercise of the remedy

Once the object is sold or vested in satisfaction of the debt, the debtor or any of the interested persons cannot redeem it by paying the full amount of the secured debt to the secured creditor.<sup>174</sup> To protect the debtor from the secured creditor's abuse in exercise of this remedy, the Convention states that the secured creditor should ensure that all the interested persons (including the debtor) agree that ownership of (or any other interest of the debtor in) any object covered by the security interest shall vest in the secured creditor.<sup>175</sup> This can only be accomplished after the default has occurred and the secured creditor should not

<sup>168</sup> Beale, Bridge, Gullifer, Lomnicka (n 30) 621; See also *Heath and Another v Pugh* (1880-81) L.R. 6 Q.B.D. 345; *Sadler v Worley* [1894] 2 Ch. 170.

<sup>169</sup> This may also be a reason why the secured creditor may wish to exercise this remedy. In contrast, a sale of the object would require the secured creditor to account for proceeds to the debtor. See *Watson v Marston* (1853) 4 De GM & G 230, 43 E.R. 495.

<sup>170</sup> The position is different under English law where even an absolute foreclosure can be opened provided that the debtor has good reasons. See *Campbell v Holyland* (1877) 7 Ch. D. 166.

<sup>171</sup> C Gnatek, 'The New Mortgage Foreclosure Law: Redemption and Reinstatement' (1989) U Ill L Rev 471, 477.

<sup>172</sup> *Wood* (n 8) 366; See also *Wallace v Evershed* [1899] 1 Ch. 891; *In re Continental Oxygen Company* [1897] 1 Ch. 511.

<sup>173</sup> Art 9(1), (2), the Convention. The position is similar under Art 9 UCC. See *White and Summers* (n 57) 899.

<sup>174</sup> Art 9(4), the Convention.

<sup>175</sup> Art9(1), the Convention.

insist on including the term permitting it to vest the object in satisfaction of the debt in the security agreement.<sup>176</sup> In some cases, the agreement of all interested persons may not always be obtained either because some of them cannot be located<sup>177</sup> or because they refuse to concur. This does not mean that the secured creditor is precluded from exercising the remedy and it can obtain a court order stating that the ownership or any other interest held in the object by the debtor should vest in the secured creditor in or towards satisfaction of the debt.<sup>178</sup> But the court should only grant such an order provided that the amount of the secured obligation to be satisfied by such vesting is commensurate with the value of the object.<sup>179</sup> For example, the secured creditor may have a security interest in \$150m worth aircraft to secure the repayment of a loan worth \$10m. If the secured creditor applies for a court order to vest the object in satisfaction of the debt, the order should be refused since the value of the object greatly exceeds the amount of the debt.<sup>180</sup> In contrast, if the amount of the debt is \$100m and it would cost the junior secured creditor \$35m to repay the debt owed by the debtor to the senior secured creditor, the court may agree to grant a vesting order to the junior secured creditor.<sup>181</sup> This should be the case because the amount of the debt coupled with the payment which the junior secured creditor should make to the senior secured creditor is commensurate with the value of the object.<sup>182</sup> If the value of the object is less than the amount of the secured debt, the secured creditor may accept it in partial satisfaction of the debt<sup>183</sup> and claim the remaining part of the debt from the debtor. This follows from the provision of the Convention stating that ownership (or other interest held by the debtor in the object) should vest in the secured creditor in or towards satisfaction of the debt.<sup>184</sup> So if the value of the aircraft is \$100m and the amount of the debt is \$150m, the secured creditor can accept the object in partial satisfaction of the debt and claim the deficiency from the debtor.

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<sup>176</sup> Similarly, under English law foreclosure cannot be exercised prior to default. See *Williams v Morgan* [1906] 1 Ch. 804.

<sup>177</sup> *In re Continental Oxygen Company* [1897] 1 Ch. 511.

<sup>178</sup> Art 9 (2), the Convention.

<sup>179</sup> Art 9(3), the Convention.

<sup>180</sup> See Goode (9) 186, Illustration 6.

<sup>181</sup> See Goode (n 9) 186, Illustration 7.

<sup>182</sup> This is the effect of Art 9(3) of the Convention.

<sup>183</sup> Art 9(1), the Convention.

<sup>184</sup> Art 9(1), the Convention. See also the discussion above.

The exercise of this remedy is not confined to the senior secured creditor, and junior creditors as well as other interested persons may accept the object in partial or full satisfaction of the secured debt. For example, if the debtor grants security interests in its aircraft to SC1, SC2 and SC3, any one of them can accept the object. If SC2 decides to accept the object in satisfaction of the debt, its interest in the aircraft will be subject to the interest of SC1, but free from the interest of SC3.<sup>185</sup> To obtain an unencumbered title to the aircraft, SC2 would have to pay the SC1 full amount of the debt owed to it by the debtor which should be done before SC1 disposes of the object by sale.<sup>186</sup>

#### 2.2.4 Relief pending final determination

Where the debtor disputes the creditor's<sup>187</sup> right to exercise a remedy and the matter is decided by the court, its resolution may take considerable time, even years.<sup>188</sup> During this time, the object may deteriorate significantly which may reduce the value of the creditor's interest in it.<sup>189</sup> The delays associated with court proceedings may also deprive the creditor of the opportunity to earn income from use or management of the object.<sup>190</sup> To address these issues, the Convention permits the creditor, who adduces evidence of default by the debtor, to request a court for a speedy relief order<sup>191</sup> which can take the form of a) preservation of the object and its value, b) possession, control or custody, c) immobilisation and d) lease or (where not covered by the above options) management of the object and the income therefrom.<sup>192</sup> In the case of aircraft and railway objects, the speedy relief order can also take the form of sale, but this can only be achieved if both the

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<sup>185</sup> Art 9(5), the Convention.

<sup>186</sup> Art 9(4), the Convention. For a similar position under English law see *Union Bank of London v Ingram* (1881-82) L.R. 20 Ch. 463.

<sup>187</sup> This remedy is not confined only to the secured creditor and may be exercised by all creditors, such as conditional seller under a reservation of title agreement and lessor under the leasing agreement.

<sup>188</sup> J Atwood, 'The Status of the Mobile Equipment (Cape Town) Convention – Arrival of an International Registration System' (2006) UCC LJ 1 Art 3.

<sup>189</sup> Goode (n 9) 190.

<sup>190</sup> *Ibid* 190.

<sup>191</sup> This remedy is available subject to the declaration which may be made by a Contracting State under Art 55 of the Convention. In accordance with this declaration, the Contracting State may declare that it will not apply the provisions of Art 13 (on speedy relief) and Art 43 (on jurisdiction of courts granting speedy relief) wholly or in part. This remedy should also be exercised in a commercially reasonable manner. See Art 13(4) of the Convention.

<sup>192</sup> Art 13(1), the Convention.



debtor and the creditor specifically agree to this option.<sup>193</sup> Just how speedy the relief should be may depend on the declaration made by the Contracting State. For example, Panama declared that in relation to orders relating to a) preservation; b) possession, control or custody; and c) immobilisation of the object, ‘speedy relief’ should be taken to mean seven working days and in relation to d) lease or management, it should mean twenty working days.<sup>194</sup> When implementing any order of the court the creditor may fail to perform its obligations to the debtor. For example, an immobilised train wagon may be left to deteriorate, an aircraft taken for preservation may be leased and the creditor may misapply rental payments or the sale of the object may not be conducted in a commercially reasonable manner. In addition, the dispute between the creditor and the debtor may ultimately be decided in the debtor’s favor. To protect the interested persons from these events, the court may require the creditor to notify them of the request for the speedy relief.<sup>195</sup> In addition, the court may impose on the creditor any terms which it considers necessary.<sup>196</sup> For example, the creditor may be required to pay damages to the debtor for the loss suffered as a result of the order if the creditor’s claim fails.<sup>197</sup>

### 3. Remedies available under the Protocols

#### 3.1 Aircraft Protocol: de-registration; export and physical transfer of the aircraft object from the territory in which it is situated

##### Purposes

Once the aircraft object is repossessed, the creditor<sup>198</sup> may wish to move it to another country if, for example, it considers that sale of the object in that country is likely to generate greater proceeds which may help to reduce or discharge the debt. To achieve this objective, the creditor may have to ensure that the purchaser will be able to register as a new owner and to operate the aircraft in the country of

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<sup>193</sup> Art X(3) of the Aircraft Protocol and Art VIII(3) of the Luxembourg Protocol.

<sup>194</sup> For a full list of declarations by Contracting States under Art 55 see:

<<http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/article55.htm> > last visited on April 13, 2001.

<sup>195</sup> Art 13(3), the Convention.

<sup>196</sup> Art 13(2), the Convention.

<sup>197</sup> Goode (n 9) 191.

<sup>198</sup> The remedies under the Protocols are not confined to secured creditors and may be exercised by all creditors, i.e. conditional seller and lessor.

new nationality. This, however, may not be possible until the aircraft is de-registered or deleted from the register where it is currently registered because the Chicago Convention, to which many countries are parties, prohibits dual registration of the aircraft nationality.<sup>199</sup> To this end, the Aircraft Protocol provides that the creditor may a) de-register the aircraft and b) procure its export and physical transfer from the territory in which it is situated to another country.<sup>200</sup> This process does not involve de-registration of the aircraft object from the records of the International Registry where the interests held in the object are registered. The process of de-registration is primarily concerned with deletion of the aircraft object from the records of a national registry authority maintaining an aircraft registry in a Contracting State.<sup>201</sup> Once the aircraft is de-registered from the current records of the registry authority, its new nationality can be re-registered in the registry authority of another country.<sup>202</sup> The remedies of de-registration and export and physical transfer of the aircraft cannot be exercised without the debtor's consent, but there is no need to stipulate for this consent in the agreement giving rise to the international interest and it can be obtained at a later stage.<sup>203</sup> In addition, the creditor should also obtain a prior consent in writing of the holder of any registered interest ranking in priority to that of the de-registering creditor.<sup>204</sup> The remedies of de-registration and export and physical transfer should be exercised in a commercially reasonable manner.<sup>205</sup> The remedy shall be deemed to be exercised in a commercially reasonable manner if it is exercised in conformity with a provision of the agreement unless it is manifestly unreasonable.<sup>206</sup> The presumption that the provision of the agreement is commercially reasonable unless manifestly unreasonable is a signal to the courts that great reliance should be placed on the wording of the contract and that bargains between the parties should not be easily disturbed.<sup>207</sup> The provision is likely to be considered manifestly unreasonable if it contradicts established

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<sup>199</sup> Art 18, The Convention on International Civil Aviation, signed at Chicago on 7 December 1944.

<sup>200</sup> Art IX(1), the Aircraft Protocol.

<sup>201</sup> For a definition of a registry authority see Art I(o) of the Aircraft Protocol.

<sup>202</sup> Art 18, the Chicago Convention.

<sup>203</sup> Art IX(1), the Aircraft Protocol. See Goode (n 9) 114.

<sup>204</sup> Art IX(2), the Aircraft Protocol.

<sup>205</sup> Art IX(3), the Aircraft Protocol.

<sup>206</sup> Art IX(3), the Aircraft Protocol.

<sup>207</sup> Goode (9) 181.

international commercial practice which can be observed in the industry. For example, if the only objective of the creditor seeking to procure de-registration of an airworthy aircraft is to make it appear as if it has been withdrawn from use or destroyed, this may be considered as manifestly unreasonable. Keeping a high value airworthy aircraft in a hangar instead of using, leasing or selling it may lead to accumulation of unnecessary expenses as well as to loss of profit which could have been earned had it been kept in operation or sold.

#### Exercise of the remedies

The Protocol provides for two routes which may be utilised in order to procure de-registration and export of the aircraft from the territory in which it is situated. Provided that a Contracting State has made a declaration that it will apply Article XIII of the Aircraft Protocol,<sup>208</sup> the debtor can issue an irrevocable de-registration and export request authorisation (IDERA) and submit it for recordation to the relevant registry authority.<sup>209</sup> The IDERA should indicate the person in whose favor the authorisation has been issued or name its certified designee.<sup>210</sup> Only the authorised party or its certified designee should be able to procure de-registration and export and physical transfer of the aircraft which should be done in accordance with the authorisation and applicable aviation safety laws and regulations.<sup>211</sup> Once the IDERA is issued it cannot be revoked by the debtor without the written consent of the authorised party.<sup>212</sup> If the Contracting State has not made the above mentioned declaration, the creditor cannot rely on this route, but it can still submit the IDERA to the registry authority.<sup>213</sup> In this case, the registry authority will be bound to honor its request provided that the authorised party complies with three requirements.

First, it should observe any applicable safety laws and regulations.<sup>214</sup> Secondly, the IDERA should be properly submitted by the authorised party.<sup>215</sup> There is no indication what should amount to a proper submission, but the form of

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<sup>208</sup> Art XIII(1), Art XXX(1), the Aircraft Protocol.

<sup>209</sup> Art XIII(2), the Aircraft Protocol.

<sup>210</sup> Art XIII(3), the Aircraft Protocol.

<sup>211</sup> Art XIII(3), the Aircraft protocol.

<sup>212</sup> Art XIII(3), the Aircraft protocol.

<sup>213</sup> Art IX(5), the Aircraft Protocol.

<sup>214</sup> Art IX(5), the Aircraft Protocol.

<sup>215</sup> Art IX(5)(a), the Aircraft Protocol.

the IDERA annexed to the Protocol can probably be used as an example. According to this form, the IDERA should name the issuer of the request and the authorised party; identify the aircraft object by the name of the manufacturer, serial number and registration mark or number; indicate that the authorised party is entitled to procure de-registration and export and physical transfer without the issuer's consent. It should probably be sent by wire or fax, but presumably the IDERA sent by post should also suffice.<sup>216</sup> Thirdly, the registry authority may require the authorised party to certify that all registered interests ranking in priority to that of the creditor in whose favor the authorisation has been issued have been discharged or that the holders of such interests have consented to de-registration and export.<sup>217</sup> If the secured creditor proposes to de-register and export the aircraft without leave of the court, it should give reasonable prior notice in writing to the interested persons about proposed de-registration and export.<sup>218</sup>

### 3.2 The Luxembourg Protocol: export and physical transfer of railway objects and the public service exemption

Similar to the Aircraft Protocol, the Luxembourg Protocol adds the remedy of export and physical transfer of the railway objects which may be exercised by all creditors in addition to the remedies available under the Convention.<sup>219</sup> Should the debtor default, the Luxembourg Protocol allows the creditor to move the railway object to another country where its sale or lease may bring greater sums. The creditor can only transport the railway object if the debtor and any holder of a registered interest ranking in priority to that of the creditor consent to the exercise of this remedy.<sup>220</sup> In addition, the secured creditor who intends to exercise this remedy extra-judicially should send notice about the proposed export to interested persons.<sup>221</sup>

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<sup>216</sup> W Boston, 'Registration of Aircraft and Recording of Security Instruments under Federal Law' (1994) 48 Consumer Fin L Q Rep 466, 471.

<sup>217</sup> Art IX(5), the Aircraft protocol. This is also the position under the United States Federal Registration and Recording Statutes. See Boston (n 216) 471.

<sup>218</sup> Art IX(6), the Aircraft Protocol. The requirement of notice follows that of Art 8(4) of the Convention.

<sup>219</sup> Art VII, the Luxembourg Protocol.

<sup>220</sup> In case of the holders of prior ranking registered interests, the creditor should obtain a prior written consent. See Art VII(2) of the Luxembourg protocol.

<sup>221</sup> Art VII(6), the Luxembourg Protocol.

One of the most difficult issues which had to be resolved by the drafters of the Protocol relates to the fact that as well as presenting a valuable asset against which finance can be raised, trains and other railway objects may be exceptionally important in transportation of passengers and freight.<sup>222</sup> Repossession of the railway object may cause great disruption to the carriage of passengers and goods which may have negative economic and political consequences for the Contracting States.<sup>223</sup> In other words, some balance had to be found between the interests of the creditor and the interests of general public and Contracting States. The discussions on the conflict between the necessity to keep trains running irrespective of the debtor's default and the availability of adequate remedies for the creditor resulted in a the so-called 'public service exemption' - an unusual solution, but not unknown to some jurisdictions.<sup>224</sup> Under the public service exemption, a Contracting State may declare that it will continue to apply rules of its domestic law in force at that time which preclude, suspend or govern the exercise of the remedies specified in the Convention and the Protocol in relation to railway rolling stock habitually used for the purpose of providing a service of public importance.<sup>225</sup> In effect, this may mean that the creditor may be deprived of all the remedies which are otherwise available to it under the Convention and the Protocol. Clearly, this may hinder the availability and cost of credit, unless the interest of the creditor is adequately protected.

First, since the Contracting State will have to submit a declaration which may preclude the exercise of remedies, the creditor will be aware that its interest in the railway object may not be adequately protected in this State.<sup>226</sup> The creditor will then be able to assess the risks associated with financing a debtor who operates the railway object in this country and either increase the interest rate or refuse to provide a loan altogether.<sup>227</sup> Secondly, the declaration may only be made in relation to railway rolling stock habitually used for the purpose of providing a service of public importance. Whether the object is used habitually (or

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<sup>222</sup> B Bodungen and K Schott, 'The Public Service Exemption under the Luxembourg Rail Protocol: a German Perspective' (2007) *Unif L Rev* 573, 577.

<sup>223</sup> Bodungen and Schott (n 222) 577.

<sup>224</sup> H Rosen, 'The Luxembourg Rail Protocol: A Major Advance for the Railway Industry' (2007) *Unif L Rev* 427, 441 referring to the UK Railway Act 1993, s 30.

<sup>225</sup> Art XXV(1), Luxembourg Protocol.

<sup>226</sup> Rosen (n 224) 439.

<sup>227</sup> *Ibid* 439.

occasionally) and whether it provides a service of public importance (and not merely interest) is a question of fact which should be decided by the Contracting State.<sup>228</sup> When considering these questions, such factors as volume of traffic, perception of public importance of the service in the Contracting State, availability of other services or means of transport and, in the case of carriage of freight, the nature of transported goods may be relevant.<sup>229</sup> Thirdly, the Protocol provides for a solution which can help to adequately protect the interest of the creditor while keeping the railway object in operation. Under this scheme, once the debtor is in default, any person, including a governmental or other public authority can take possession or control of, or use the railway object.<sup>230</sup> This person should preserve and maintain the railway object until such time when its possession, control or use can be restored to the creditor.<sup>231</sup> This means that if the object deteriorates or is left uninsured, the person responsible for its preservation and maintenance may be held liable for loss suffered by the creditor. Most importantly, even though the creditor may not take possession and dispose of the railway object, the above mentioned person should pay to the creditor either a) such amount as that person would pay under the rules of the law of the Contracting State or b) the market lease rental in respect of such railway rolling stock, whichever is the greater.<sup>232</sup>

This arrangement can adequately protect the creditor's interest because it enables the creditor to receive payment which it would have been entitled to under the agreement with the debtor even though it cannot take possession and dispose of the object.<sup>233</sup> If the creditor is paid the amount of lease rentals, it should be calculated based on what would be available to the creditor in the current market, which may differ to the amount agreed in the contract between the creditor and the debtor. This way, the creditor is placed into the position in which it would have been had it repossessed and leased the object itself.<sup>234</sup> The creditor's interest

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<sup>228</sup> R Goode, *Official Commentary to the Convention on International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock* (Rome, UNIROIT 2008) 109.

<sup>229</sup> *Ibid* 109.

<sup>230</sup> Art XXV(2), the Luxembourg Protocol.

<sup>231</sup> Art XXV(2), the Luxembourg Protocol.

<sup>232</sup> Art XXV(3), the Luxembourg Protocol.

<sup>233</sup> H Rosen, 'The Luxembourg Rail Protocol: A Major Advance for the Railway Industry' (2007) *Unif L Rev* 427, 440.

<sup>234</sup> Rosen (n 224) 441.

is further protected by the requirement of the Protocol that the first payment should be made within ten calendar days of the date on which such power is exercised by the authorised person and that all subsequent payments should be made on the first day of each month.<sup>235</sup> If the sum paid to the creditor exceeds the amount owed to it, the surplus should be distributed among holders of subsequent interests in the order of priority.<sup>236</sup> Although this scheme can provide a much needed balance between the interests of the creditor and that of general public, the delegates of some Contracting States were not ready to accept it.<sup>237</sup> To allow the Contracting State to block repossession without compensating the creditor, the Protocol permits it to declare that it will not apply the rules on payment to the creditor in those cases where it may be precluded from exercising the remedies in relation to the railway objects.<sup>238</sup> But in making such a declaration, the Contracting State is required to take into consideration the interests of the creditor and the effect of the declaration on the availability of credit.<sup>239</sup> Finally, even if the Contracting State makes such a declaration, the authorised person may still agree with the creditor to utilise the scheme designed under the Protocol.<sup>240</sup>

#### 4. Remedies on insolvency

##### General

In some cases the secured creditor will need to enforce its remedies when the debtor becomes insolvent. This may prove to be difficult because various jurisdictions tend to impose restrictions and compulsory freezes on the enforcement of remedies by secured creditors in such circumstances.<sup>241</sup> The ability to exercise a remedy may depend on the type of the insolvency proceeding involving the debtor.<sup>242</sup> For example, under English law, one of the purposes of administration is to rescue the company.<sup>243</sup> To achieve this end the administrator

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<sup>235</sup> Art XXV(3), the Luxembourg Protocol.

<sup>236</sup> Art XXV(3), the Luxembourg Protocol.

<sup>237</sup> Bodungen and Schott (n 222) 580.

<sup>238</sup> Art XXV(3), the Luxembourg Protocol.

<sup>239</sup> Art XXV(6), the Luxembourg Protocol.

<sup>240</sup> Art XXV(4), the Luxembourg Protocol.

<sup>241</sup> Wood (n 8) 385.

<sup>242</sup> D Turing, 'Creditor's Remedies in Insolvency' (1994) JIBL 46.

<sup>243</sup> Para 3(1), Schedule B1, Insolvency Act 1986 indicates that the administrator's main objectives are: a) to rescue the company as a going concern; or b) to achieve a better result for the company's creditors as a whole than would be likely if the company were wound up; or c) to realise property in order to make a distribution to one or more secured or preferential creditors. See also In re

may need to use or dispose of the charged objects and repossession of such objects by the secured creditor may prevent it from achieving its objectives.<sup>244</sup> This means that in the case of administration, the secured creditor may not be able to exercise its remedies unless leave of court or the administrator's permission can be obtained.<sup>245</sup>

In some jurisdictions, bankruptcy legislation effectively freezes the bankrupt debtor's assets and automatically stays all actions against the charged objects of the debtor by the secured creditor.<sup>246</sup> The obstacles which are created by insolvency laws of various jurisdictions are often underpinned by such policies as the need to promote equality for creditors during the debtor's insolvency, to rescue the company as a going concern<sup>247</sup> as well as to protect the economy and jobs.<sup>248</sup> Such restrictions may significantly impair the strength of the security interest: if the remedies are not available to the secured creditor in the debtor's insolvency, they are not available when they are most needed.<sup>249</sup> The need for clear rules and assurance of protection of the secured creditor's rights in the debtor's insolvency may be particularly acute when the type of equipment governed by the Convention and the Protocols is taken into account. First, the level of financing of aircraft, railway and space objects can be exceptionally high. Secondly, such objects usually have a long economic life which may mean that long-term loan facilities may be needed to finance their acquisition or lease. Thirdly, despite long economic life expectancy, aircraft, railway and space objects may be susceptible to rapid deterioration if not used or maintained regularly. This feature of the objects may be particularly relevant if the debtor is involved in

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Atlantic Computer Systems Plc [1990] BCC 859; P Fidler, 'Administration: Leave to Enforce Security on Property Rights' (1991) JIBL 78, 79.

<sup>244</sup> M Elland-Goldsmith, 'Real Security over Personal Property in English Law' (1995) IBLJ 145, 167.

<sup>245</sup> Para 43, Schedule B1, Insolvency Act 1986 For example, leave is likely to be refused if enforcement of property rights of secured creditor is likely to cause disruption which would be out of proportion to the loss which it would suffer if the leave were not granted. See Fidler (n 243) 80; Wood (n 4) 404; Innovate Logistics Ltd (In admin.) v Sunberry Properties Ltd [2009] B.C.C. 164.

<sup>246</sup> This is the position under the United States Bankruptcy Code. For a suggestion that collective exercise of the exception to this rule by aircraft financiers under s. 1110 of the Bankruptcy Code may help such creditors to eliminate market competition and force the debtor to pay higher-than-market-rate rental payments under leases see J Janaitis, 'Bankruptcy Collides with Antitrust: the Need for a Prohibition Against Using S. 1110 Protections Collectively' (2008) 25 Emory Bankr Dev J 197.

<sup>247</sup> V Finch, 'Re-Invigorating Corporate Rescue' [2003] JBL 572.

<sup>248</sup> Wood (n 8) 363.

<sup>249</sup> Goode (n 9) 326.



lengthy reorganisation proceedings which may take considerable time. During this period, the debtor may not be able to properly maintain the object, and the secured creditor may be precluded from repossessing it. Finally, such objects can move across the borders or leave the Earth altogether which can complicate their location and repossession.<sup>250</sup> Because of these common features of the types of equipment governed by the Convention and the Protocols, uncertainty with respect to remedies in the case of the debtor's insolvency may impede the availability and cost of credit.

To address these issues, the Convention and the Protocols provide for a set of rules governing the rights of the creditor in the debtor's insolvency.<sup>251</sup> The aim of these rules is, generally, to ensure that if the insolvency-related event occurs,<sup>252</sup> the secured creditor can either a) repossess the charged object or b) ensure that the insolvency administrator or the debtor, as the case may be,<sup>253</sup> cures all past defaults and undertakes to perform its future obligations.<sup>254</sup> The insolvency regime under the Convention and the Protocols will only apply if the Contracting State, that is a primary insolvency jurisdiction,<sup>255</sup> makes a declaration to this effect.<sup>256</sup> Alternatively, the Contracting State may choose not to make a declaration and apply its own insolvency law. The provisions of the Protocols dealing with the remedies on insolvency come in several alternatives and the Contracting State may adopt any of these alternatives.<sup>257</sup> Whatever alternative the Contracting State selects, it must be adopted in its entirety.<sup>258</sup> There is no need to select only one such alternative: it is possible to apply separate alternatives to

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<sup>250</sup> A Sabino, 'Flying the Unfriendly Skies: A Year of Reorganizing Airlines, Aircraft Lessors, and the Bankruptcy Code' (1992) 57 J Air L Com 841, 843-844.

<sup>251</sup> Art XI, the Aircraft Protocol, Art IX, the Luxembourg Protocol. See also R Goode, 'International Interests in Mobile Equipment: A Transnational Juridical Concept' (2003) 15 Bond L Rev 9, 18.

<sup>252</sup> As defined in Art 1(l) of the Convention and Art I(m) of the Aircraft Protocol.

<sup>253</sup> Insolvency administrator means a person authorised to administer the reorganisation or liquidation, including one authorised on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law. See Art 1(k) of the Convention.

<sup>254</sup> Goode (n 9) 322.

<sup>255</sup> This would be a Contracting State in which the center of the debtor's main interests is situated. See Art I(n) of the Aircraft Protocol.

<sup>256</sup> Art XI(1), Art XXX(3), the Aircraft Protocol. See also R Goode, 'The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing' (2003) 36 UCC LJ 2 Art 1.

<sup>257</sup> Goode (n 9) 327.

<sup>258</sup> Ibid 327.

different types of insolvency proceedings.<sup>259</sup> But even if the Contracting State declares that it will apply one of the available alternatives, the parties may still exclude its application by a written agreement.<sup>260</sup> The Aircraft Protocol provides for Alternative A, the ‘hard’ or rule-based version and Alternative B, the ‘soft’ or discretion-based version. The Luxembourg Protocol adds Alternative C to these options.<sup>261</sup>

#### Alternative A

Under Alternative A of the Aircraft Protocol, the enforcement of secured creditor’s remedies is effectively stayed until either a) the end of the waiting period and b) the date on which the creditor would be entitled to possession of the aircraft object if this provision of the Protocol did not apply, whichever of these dates is earlier.<sup>262</sup> The waiting period may be specified in a declaration of the Contracting State stipulating which of the available Alternatives should apply in the case of the debtor’s insolvency.<sup>263</sup> For example, China, Jordan, Mongolia and New Zealand among other countries declared that they will apply Alternative A in its entirety to all types of insolvency proceedings and that the waiting period for these purposes should be 60 days. The waiting period in Nigeria is declared to be 30 days and in Malaysia 40 days.<sup>264</sup> With regard to the second option, i.e. the date on which the creditor would be entitled to possession, it could be argued that if this provision of the Protocol did not apply, it would mean that the Contracting State either opted for another Alternative or did not make the declaration. In this case, it could be suggested that the rules of Alternative A would not apply at all and applicable insolvency law would apply instead. What was probably meant by the reference to the date when the creditor would be entitled to possession is the situation where the Contracting State has made the declaration and opted for Alternative A, but did not specify the length of the waiting period. In this case, the waiting period or any other date on which the creditor would be entitled to

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<sup>259</sup> Ibid 327.

<sup>260</sup> Art IV(3), the Aircraft Protocol.

<sup>261</sup> Goode (n 9) 327.

<sup>262</sup> Art XI, Alternative A(2).

<sup>263</sup> Alternative A(3).

<sup>264</sup> The full list of countries which opted for Alternative A and specified the waiting period is available at: <[http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/articleXXX\(3\).htm](http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/articleXXX(3).htm)>. Last visited on April 19, 2011.

possession under the applicable law would become relevant. Another option is if the Contracting State specified the length of the waiting period, e.g. 60 days, but under the applicable insolvency law, the aircraft financier is entitled to a shorter waiting period, e.g. 30 days. In this case, the creditor may be entitled to proceed under Alternative A on the expiration of the shorter period. During this period, enforcement of the secured creditor's remedies is stayed and the debtor (or the insolvency administrator) is given a breathing space to assess its position and decide whether on the expiration of this period it will cure all past defaults<sup>265</sup> and agree to perform future obligations under the agreement or whether it will give possession of the aircraft object to the creditor.<sup>266</sup> For example, if the lease of the aircraft is supposed to run for another seven years when the debtor/lessee becomes insolvent, the waiting period should enable it to assess whether to continue the lease of the aircraft. If operating the aircraft would help it rescue the business, it may cure past defaults (e.g. pay any accrued rental payments and interest) and agree to perform its future obligations under the lease (e.g. pay any further rental payments on time, keep the aircraft well maintained and insured etc.). On the other hand, if the debtor does not own the majority of its aircraft and leases them instead, then in order to rescue the business it may need to reduce its fleet. This may be the case if operating the leased aircraft does not generate enough profit to cover the costs of maintenance and rental payments. If this is the position, then once the waiting period expires, the debtor/lessee may decide to return the aircraft to the creditor/lessor. When the creditor/lessor regains possession of the aircraft, it can enter into a new lease, sell it or deal with it as it considers best (since the lessor is the owner of the object). But this should not necessarily mean that the creditor should be prevented from exercising any other remedies against the debtor: it can still demand payment of unpaid rental payments which accrued at least up to the moment when the lease was rejected by the debtor.<sup>267</sup>

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<sup>265</sup> This does not include default relating to the opening of the insolvency proceedings, because this type of default cannot be cured. Alternative A(7). See Goode (n 9) 327.

<sup>266</sup> Alternative A (2), (7).

<sup>267</sup> Alternative A(9) states that no exercise of remedies permitted by the Convention or the Aircraft Protocol may be prevented or delayed after the expiration of the waiting period. Art 12 of the Convention states that the creditor may exercise any additional remedies permitted by the applicable law as long as they are not inconsistent with the requirements of the Convention. Accordingly, if the applicable law allows the lessor to claim payment of the unpaid rental payments which accrued before termination of the lease, the lessor should be able to claim such amounts under Alternative A of Aircraft Protocol.

If the debtor chooses to retain the aircraft object, cures past defaults and agrees to perform all future obligations under the agreement, but later fails to pay rental payments under the lease, the question which may arise is whether the debtor may argue that a new waiting period should be imposed allowing it to cure the defaults. In one case, decided under US law, a debtor-in-possession and its secured creditor contested the right of the lessor to take possession of some 13 aircraft.<sup>268</sup> The US Bankruptcy Code imposes an automatic stay on the enforcement of secured creditor's remedies once the debtor files a petition under Chapter 11. But similar to Alternative A under the Protocol, s. 1110 of the Bankruptcy Code, generally, allows the aircraft financier to take possession of the aircraft object on the expiration of 60 day waiting period unless the debtor cures all defaults and agrees to perform its future obligations under the agreement. The debtor-in-possession cured all defaults within the waiting period and continued to operate the leased aircraft, but later failed to tender a maintenance reserve payment under the lease. The creditor/lessor insisted on its immediate right to take possession of the aircraft and the debtor objected by stating that it could still cure the default because the waiting period continued to run. The confusion stemmed from the wording s.1110 of the Bankruptcy Code which effectively sets two different waiting periods, one of 30 days and another of 60 days. The debtor claimed that if it cured past defaults during the 60 day waiting period, but later committed another default, it should be granted another 30 days to cure such default. This interpretation of s.1110 was rejected by the court because it would mean that the debtor would have a continuing waiting period for each default committed after the expiration of 60 day stay. This could prevent the creditor from repossessing the aircraft and defy the purpose of the exemption from the automatic stay granted to aircraft financiers by s. 1110. It was held that 30 day period referred to the defaults committed during the 60 day waiting period: if the default occurred on the 58<sup>th</sup> day of the waiting period, the debtor would have 30 days to cure it (and not just two days); but if the default occurred even three days after the 60 day waiting period elapsed, the creditor should be able to repossess the aircraft.

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<sup>268</sup> In re Western Pacific Airlines (1998) 219 B.R. 298, 39 Collier Bankr. Cas.2d 1084.

A similar situation may occur under Article 2 and Article 7 of Alternative A of the Aircraft Protocol because it effectively sets two different dates at which the decision to either return the aircraft or cure the defaults should be taken. For example, if the Contracting States declares that the waiting period under Article 2(a) of Alternative A should be 60 days, but under Article 2(b) an aircraft financier would be entitled to possession within 40 days of the occurrence of the insolvency related event, then several consequences may follow. First, the secured creditor can insist that since Article 2 stipulates that the earlier of the dates should be relevant, once 40 day period expires, it should be entitled to either repossess the object or demand cure and commitment to performance of future obligations. Secondly, if the debtor retains the object, but commits another default, the timing of this default may become relevant. If the default occurs on the 37<sup>th</sup> day of the 40 day waiting period, should it be extended to allow cure and, if so, for how long (40 or 60 days?). If the default occurs after the waiting period expires, should a new waiting period be imposed? It is suggested that the answer to both of these questions should be in the negative: once the waiting period expires it should no longer be extended irrespective of whether the default occurred during such period or after its expiration. The two periods on the expiration of which the debtor should make a decision are intended to be mutually exclusive. This means that the decision should be made no later than the earlier of a) the expiration of the waiting period and b) the date on which the creditor would be entitled to possession under the applicable law. This language of Alternative A seems to exclude the possibility that the existence of two variants of relevant dates may mean that the date on which the creditor should be entitled to repossession or cure could be further extended. In addition, with respect to the post-waiting period defaults, Article 7 of Alternative A indicates that a second waiting period should not apply in respect of a default in the performance of future obligations. It seems that the same logic should apply in the case of the defaults which occurred within the waiting period: if they are not cured by the time such period expires, the creditor should be able to take possession of the aircraft object. Otherwise, the waiting period could be extended for another 40 or 60 days, which may impair the protection given by Alternative A to the creditors.

Unless and until the creditor is given an opportunity to take possession of the aircraft object, the insolvency administrator/debtor should preserve and maintain it and its value in accordance with the agreement.<sup>269</sup> So the insolvency administrator/debtor should ensure that the aircraft remains in an airworthy condition, well maintained, repaired and insured, but it can also use the aircraft in order to preserve its value.<sup>270</sup> If the value of the aircraft diminishes, its condition deteriorates or if the interest of the creditor in the object becomes otherwise unprotected, it can apply for interim relief available under applicable law.<sup>271</sup> There is no requirement that the secured creditor should wait until the waiting period expires which means that it can apply and, presumably, obtain an interim relief during such period. This means that the court may order the debtor to pay or otherwise compensate the creditor for the loss which it may suffer as a result of the diminution of aircraft's value.<sup>272</sup> One question which may arise in relation to exercise of this remedy is whether the waiting period can be shortened or lifted in order to ensure that the creditor can protect its interest in the aircraft effectively. Alternative A does not explicitly permit variation of the waiting period as prescribed by the declaration of the Contracting State. Nor does it allow varying the date on which the creditor would be entitled to possession under the applicable law. Moreover, the Protocol provides that although parties can derogate from selected provisions of the applicable Alternative, this is not permitted in relation to the provisions on the length of the stay.<sup>273</sup> On the other hand, if the stay cannot be lifted, the creditor may be left without an effective remedy:<sup>274</sup> rather than attempting to obtain payments from the insolvent debtor, the creditor may wish to repossess the aircraft without having to wait until the stay expires.

Finally, Alternative A provides that the remedies of de-registration and export of the aircraft object should be made available to it by the registry authority no later than five working days after the date on which the creditor notifies such authorities that it is entitled to procure those remedies in accordance with the

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<sup>269</sup> Alternative A(5)(a).

<sup>270</sup> Alternative A(6).

<sup>271</sup> Alternative A(5)(b).

<sup>272</sup> W Foster, 'Aircraft Lessors Entitled to Adequate Protection during the S.1110 60-day Period' (2010) *Am Bankr Inst J* 18, 67.

<sup>273</sup> Art IV(3) of the Aircraft Protocol.

<sup>274</sup> G Gerstell and K Hoff-Patrinou, 'Aviation Financing Problems under Section 1110 of the Bankruptcy Code' (1987) 61 *Am Bank L J* 1, 29.

Convention.<sup>275</sup> The registry authority is also required to expeditiously co-operate with and assist the creditor in the exercise of these remedies which should be done in accordance with the applicable safety laws and regulations.<sup>276</sup> But the creditor should be in fact entitled to exercise these remedies. So if the obligation to return the aircraft has not yet arisen or if the debtor decides to cure the defaults and perform all future obligations, the creditor may not be entitled to procure de-registration and export of the aircraft.<sup>277</sup>

#### Alternative B

Alternative A provides the debtor with a period of time during which it can assess its position and decide whether to cure the defaults or return the object. During such time, the creditor is not, generally, entitled to repossess the object and if the debtor decides to cure the defaults, the creditor may not be able to take possession of the aircraft after the expiration of the relevant date. It is a ‘hard’ or rule-based version because it sets a clear cutting off point after which the creditor may demand either to repossess the object or to insist on the curing of the defaults. In contrast, Alternative B is a ‘softer’ or more debtor-protective version because it does not specify a date after which the debtor should make the decision. Instead, upon the occurrence of the insolvency-related event, the debtor is required to give notice to the creditor indicating whether it will a) cure all defaults and undertake to perform its future obligations under the agreement and related transaction documents or b) give the creditor the opportunity to take possession of the aircraft object in accordance with the applicable law.<sup>278</sup> But the notice should only be given upon the request of the creditor and within the time specified in the declaration of the Contracting State.<sup>279</sup> To this date, only one State, namely Mexico, selected Alternative B and declared that the notice of the debtor should be given to the creditor within the time period expressly indicated by the parties in the contract.<sup>280</sup> The period during which the debtor should notify the creditor

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<sup>275</sup> Alternative A(8).

<sup>276</sup> Alternative A(8).

<sup>277</sup> Goode (n 9) 328.

<sup>278</sup> Art XI, Alternative B(2) of the Aircraft Protocol.

<sup>279</sup> Alternative B(2).

<sup>280</sup> The full list of declarations under Art XXX(3) of the Aircraft Protocol is available at: <[http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/articleXXX\(3\).htm](http://www.unidroit.org/english/conventions/mobile-equipment/depositaryfunction/declarations/byarticle/articleXXX(3).htm)>.

about its decision may only start to run from the date of the request.<sup>281</sup> So if the creditor requests the debtor to notify it whether it will cure the defaults or return the object on April 20 and the contract indicates that the notice should be served within 10 days, the time will start to run from the date of the request made by the creditor. If the insolvency administrator/debtor fails to notify the creditor about its decision or if the debtor notifies the creditor that it will give it the opportunity to take possession of the object, but fails to do so, the creditor cannot repossess the object extra-judicially.<sup>282</sup> To repossess the aircraft in such circumstances the creditor will have to apply to the court for permission.<sup>283</sup> The court may (but is not obliged to) permit repossession and it may require the creditor to provide additional guarantees or comply with any terms which it may impose.<sup>284</sup> Since Alternative B, unlike Alternative A, involves an application to the court, the creditor is required to provide evidence of its claims and proof that its international interest has been registered.<sup>285</sup> This means that although registration of the international interest is not, generally, required for the purpose of enforcement of remedies, it may be necessary if the creditor has to proceed under Alternative B during the debtor's insolvency.<sup>286</sup> Finally, under Alternative B, the creditor cannot take possession of the aircraft object and sell it until the court reaches a decision concerning its claim and international interest.<sup>287</sup>

#### Alternative C

Similar to the Aircraft Protocol, the Luxembourg Protocol allows the Contracting State to choose one of the alternative versions of Article IX governing the rights of the creditor in the case of the debtor's insolvency. In contrast to the Aircraft Protocol, which states that the remedies of de-registration and export should be made available no later than five working days after the creditor's notification, Alternative A(8) of the Luxembourg Protocol extends this period to seven days. But in other terms, Alternative A under both Protocols appears to have the same effect: the debtor is given a period of time during which it should decide whether

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<sup>281</sup> Goode (n 9) 329.

<sup>282</sup> Alternative B(5).

<sup>283</sup> Alternative B (5).

<sup>284</sup> Goode (n 9) 329.

<sup>285</sup> Alternative B(4).

<sup>286</sup> Goode (n 9) 330.

<sup>287</sup> Alternative B(6).



to cure the defaults or return the object to the creditor. Under both Protocols, Alternative A displaces Article 30(3)(b) of the Convention because it precludes applicable insolvency law from imposing automatic stays or freezes aimed at stopping the creditor from exercising the remedies available under the Convention and the Protocols after the expiration of the waiting period.<sup>288</sup> Alternative B of the Luxembourg Protocol follows the terms of the same alternative under the Aircraft Protocol. But in addition to these two options, the Luxembourg Protocol adds a new Alternative C which is drafted in the terms similar to Alternative A. It aims to achieve the same result, i.e. to give the creditor the opportunity to either a) ensure that the debtor cures all defaults other than a default constituted by the opening of insolvency proceedings and promises to perform future obligations or b) to repossess the railway object.<sup>289</sup> But the waiting period is called the ‘cure period’ and is specified to start on the date of the insolvency-related event.<sup>290</sup> There is no indication in relation to how long should the cure period continue and it should probably be specified in the declaration of the Contracting State which is the primary insolvency jurisdiction. In contrast to Alternatives A and B under both Protocols, Alternative C permits the insolvency administrator/debtor to apply to court for an order suspending its obligation to return the railway object.<sup>291</sup> The suspending period should commence from the end of the cure period and last until the expiration of the agreement or its renewal.<sup>292</sup> This means that in order to be eligible for the suspension period, the insolvency administrator/debtor should apply for the court order before the expiration of the cure period.<sup>293</sup> If the insolvency administrator/debtor is granted the suspension order, the creditor cannot repossess the object during such period. To protect the creditor’s interest, the court order may require that all sums accruing to the creditor during the suspension period should be paid to it from the insolvency estate as they become due.<sup>294</sup> The suspension order should also indicate that the insolvency administrator/debtor should perform all other obligations which may arise during

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<sup>288</sup> Alternative A(9), (10) of the Aircraft and Luxembourg Protocols. See also Goode (n 9) 329.

<sup>289</sup> Alternative C(3), the Luxembourg Protocol.

<sup>290</sup> Alternative C(15).

<sup>291</sup> Alternative C(4).

<sup>292</sup> Alternative C(4).

<sup>293</sup> Goode (n 9) 307.

<sup>294</sup> Alternative C(4).

the suspension period.<sup>295</sup> This will probably mean that the insolvency administrator/debtor will have to continue to take necessary measures to preserve and maintain the railway rolling stock and its value.<sup>296</sup> In other respects Alternative C appears to follow Alternative A: during the cure period, the creditor is entitled to apply for interim relief available under the applicable law and once the cure period expires the creditor cannot be precluded from exercising the remedies under the Convention and the Protocols.<sup>297</sup>

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<sup>295</sup> Alternative C(4).

<sup>296</sup> Alternative C(6) states that the insolvency administrator/debtor shall preserve and maintain the railway rolling stock and its value until and unless the creditor is given the opportunity to take possession under paragraph 3, which deals with the cure period. But there is no reason why the same obligations should not be imposed on the insolvency administrator/debtor if it continues to retain possession of the railway objects during the suspension period.

<sup>297</sup> Alternative C(6)(B), (10), (11).

## Conclusion

The Cape Town Convention and its Protocols break new ground in an area of great complexity by providing a set of uniform substantive rules aimed at protecting the interests of a secured creditor, conditional seller and lessor in high value mobile equipment. With the creation of the concept of the international interest, the Convention effectively dispenses with the need to engage in widely debated issues of the characterisation of security interests. Rather than adopting a formal or a functional approach to defining security interests, the Convention creates a *sui generis* category of the international interest which does not depend on any domestic law and can include both true and quasi security interests. The Convention is also unique in establishing the International Registry of aircraft objects. Under the Convention, all that is needed in order to identify senior international interests and secure a priority position among other creditors of the debtor by giving notice to any subsequent holders of international interests, is to register one's international interest in the aircraft object in the International Registry. The fact that the International Registry is electronic and can be accessed from anywhere in the world can help to render the process of identification of any encumbrances in the aircraft objects transparent, speedy and cost effective, which can make financing and leasing of such objects more widely affordable. The rules of the Convention on priority among competing interests can also be praised for their clarity and simplicity. Priority of international interests is keyed to the time of registration and other considerations, such as location of the title to the object, which may be present under domestic law, are irrelevant for the purposes of the Convention. Although the general rule that a registered interest prevails over the unregistered and subsequently registered interest is subject to exceptions, the number of these exceptions is not great and they are not unfamiliar to many domestic legal systems. The availability of readily available and adequate remedies is of pivotal importance to the secured creditor, conditional seller and lessor. In this regard, the remedial scheme of the Convention is diverse and flexible and can even be added to by remedies which may be available to the creditor under applicable domestic law, provided that such remedies are not inconsistent with it. Another distinguishing feature of the Convention and the Protocols is the alternative set of rules on repossession which can be exercised by

the creditor in the case of the debtor's insolvency. At the same time, the Convention provides safeguards for protection of the debtor's interests in requiring the remedies to be exercised in a commercially reasonable manner, in indicating that, provided that the debtor meets its obligations, it should be able to exercise its right of quiet possession of the object and in ensuring that the rights of the debtor are protected in the case of the issue of an order of interim relief against it where the claims of the creditor were not successful.

Like many other legal instruments, the Convention poses some important questions with no definite answers. For instance, it is not entirely clear whether a floating security interest in aircraft or railway objects can be created and registered under the Convention and this work maintains that this can, in principle, be achieved in relation to both types of equipment. The flexible identification requirements of Article V of the Luxembourg Protocol suggest that the railway object can be broadly described by type, or item, or relate to present and future objects. This means that a floating security over present and future railway objects can be created. However, the stricter identification requirements at the stage of registration mean that a validly created floating security in railway objects could not be registered in the International Registry. The Aircraft Protocol requires unique identification of aircraft objects both at the stages of constitution and registration of the international interest. It follows that a floating security interest cannot be created in future unidentified assets of the debtor. However, if the floating security is viewed as a security in a fund of existing uniquely identifiable assets of the debtor and the debtor is given the power to deal with such assets in the ordinary course of business, then it may be possible to create and register the floating security in such assets.

Another example relates to the standard of commercially reasonable exercise of remedies, a term which is not defined by the Convention. The only guidance given by the Convention is that a remedy shall be deemed to be exercised in a commercially reasonable manner where it is exercised in conformity with a provision of the security agreement unless such a provision is manifestly unreasonable. This may give rise to some important questions as to whether, for example, the creditor owes to the debtor any duties in relation to the repossessed object and, if so, what is the extent of such duties. Another question

in relation to the standard of commercial reasonableness is what factors may be relevant in deciding whether repossession and sale of the aircraft object were conducted in a commercially reasonable manner. The answers to these questions will depend on the particular circumstances of each case and, it is hoped that future cases decided under the Convention may help to provide clearer guidance in relation to them. This work has identified a number of factors which need to be taken into account in assessing and applying this standard.

The Convention and the Aircraft Protocol have only been in force for a little over five years and it may be too soon to judge how successful these instruments are. But it is an exceptionally dynamic project with new developments unfolding every year. Forty nine countries have already become parties to the Convention and the Aircraft Protocol, with recent accessions from the Republic of Belarus, Fiji, Costa Rica and ratification from Turkey accepted by the Depository in 2011. The International Registry for aircraft objects has already seen more than 250.000 registrations which demonstrates that it works well and is used extensively.<sup>1</sup> Many leading international law firms are now advising on the issues of registration of aircraft objects in the International Registry. There are also some promising developments in relation to the establishment of the international registry for the railway objects with the meeting of the Preparatory Commission to consider the issues relating to such registry scheduled for the end of November 2011 to be held in Rome.<sup>2</sup> It will be interesting to see what identification criteria will need to be satisfied in order to register a railway object in the international registry. Once the international registry for railway objects becomes operational, the Luxembourg Protocol will also come into force. Finally, the Diplomatic Conference for the adoption of the Protocol in relation to matters specific to space objects is due to be held in February-March 2012 in Berlin, Germany.<sup>3</sup> All these factors seem to indicate that the future prospects for the Convention and its Protocols are bright and that these instruments will prove to be both intellectually engaging to legal scholars and increasingly useful to practicing lawyers worldwide.

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<sup>1</sup> See a press release to the Cape Town Convention Seminar Celebrating 10 Years, due to be held on 30 November, 2011 in Rome available at: <<http://www.unidroit.org/english/news/2011-11-30-capetown.pdf>>.

<sup>2</sup> See schedule of meetings organised by UNIDROIT available at: <<http://www.unidroit.org/english/news/calendar2011-2012-e.htm>>.

<sup>3</sup> See news release of UNIDROIT available at: <<http://unidroit.org/dynasite.cfm>>.

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